S. Hrg. 111–705

HEARING WITH SECRETARY TIMOTHY GEITHNER

HEARING

BEFORE THE

CONGRESSIONAL OVERSIGHT PANEL
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

HEARING HELD IN WASHINGTON, DC, JUNE 22, 2010

Printed for the use of the Congressional Oversight Panel

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HEARING WITH SECRETARY TIMOTHY GEITHNER

TUESDAY, JUNE 22, 2010

CONGRESS OF THE UNITED STATES,
CONGRESSIONAL OVERSIGHT PANEL,
Washington, DC.

The Panel met, pursuant to notice, at 10:03 a.m. in Room SD–192, Dirksen Senate Office Building, Elizabeth Warren, Chair of the Panel, presiding.

Present: Ms. Warren, Mr. Neiman, Mr. Silvers, Mr. McWatters, and Dr. Troske.

OPENING STATEMENT OF ELIZABETH WARREN, CHAIR, CONGRESSIONAL OVERSIGHT PANEL

Chair WARREN. This hearing of the Congressional Oversight Panel is called to order.

Good morning, Mr. Secretary. We appreciate your returning here to testify before the Congressional Oversight Panel for the fourth time.

Since your last appearance here, the panel has issued six more reports, bringing our total to 20. Our latest reports have covered a great deal of territory from the Government's interventions in specific companies such as GMAC and AIG and its broader efforts to shore up entire markets such as small business lending and housing.

The breadth of our reports reflects in many ways the breadth of your ambitions. Under your leadership, Treasury has launched at least a dozen distinct programs to address different aspects of the financial crisis. It seems clear that these efforts have had an important impact: markets have calmed greatly since the turbulent fall of 2008.

But the size and scope of these programs also reflects the variety of severe strains on our financial system. About 3,000 banks and six of our largest financial institutions are dangerously exposed to the faltering commercial real estate market. Many more banks still have not digested the toxic assets, the toxic mortgages on their balance sheets, and are now facing new demands to pay off bad mortgages they sold to Fannie and Freddie. The financial problems of these banks are straining their ability to lend to small businesses that might otherwise be driving the economic recovery and reducing unemployment, and finally, it seems clear that Treasury's efforts to reduce mortgage foreclosures is not working.

As the TARP's end date approaches, this panel must know whether Treasury has carefully monitored the financial system to assess potential risks. We must also evaluate whether Treasury has diligently measured the impact of its efforts, using credible metrics to measure the success or the failure of its programs. Put another way: Has Treasury administered TARP with the highest possible degree of transparency and accountability?

After all, reasonable people may approve or disapprove of your plan to stop foreclosures, but no one questions that its progress should be measured against clear benchmarks for success. Yet, Treasury has provided no such benchmarks.

Reasonable people may define financial stability in different ways, but everyone agrees that we can best gauge that stability by rigorously measuring the condition of our banks. Yet, Treasury has refused to call for additional stress tests in our financial system.

Reasonable people may disagree about how to help small businesses gain access to loans, but no one doubts that the solution must begin with a clear understanding of the problem. Yet, Treasury has gathered only sparse data on the small business credit crunch.

So the point is blunt: Without more candid data on bank stability, on commercial real estate, small business lending, and home mortgage foreclosure efforts, the shape and depth of the risks facing our economy remain hidden. And without more willingness to separate programs that have worked from those that have not, it is not possible to build the best defenses.

The problems in commercial real estate, small business lending, and home mortgage foreclosure grow more urgent by the day. In only three months, your office will lose the capacity to substitute better programs for those that have failed or to develop new programs to deal with coming risks. I will be very glad to see the TARP end. But I realize that time is running out to make certain that we have used this money to assure the stability of our financial system. Time is also running out to make certain that TARP money is used to help families and small businesses the way it was so quickly used to help Wall Street.

Before we proceed with the Secretary's testimony, I would like to offer my colleagues on the panel an opportunity to make their own opening remarks.

Mr. McWatters.

[The prepared statement of Chair Warren follows:]

ELIZABETH WARREN, CHAIR
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK McWATTERS
KENNETH R. TROSKE

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Congress of the United States
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Elizabeth Warren

Congressional Oversight Panel Hearing with Treasury Secretary Timothy Geithner

June 22, 2010

Good morning, Mr. Secretary. We appreciate your returning to testify before the Congressional Oversight Panel for the fourth time. We have many pressing issues to discuss.

Since your last appearance here, the Panel has issued six more oversight reports, bringing our total to 20. Our latest reports have covered a great deal of territory, from the government's interventions in specific companies such as GMAC and AIG to its broader efforts to shore up entire markets such as small business lending and housing.

The breadth of our reports reflects in many ways the breadth of your ambitions. Under your leadership, Treasury has launched at least a dozen distinct programs to address different aspects the financial crisis. It seems clear that these efforts have had an important impact: markets have calmed greatly since the turbulent fall of 2008.

But the size and scope of these programs also reflects the variety of severe strains on our financial system.

- About 3,000 banks – including six of our largest financial institutions – are dangerously exposed to the faltering commercial real estate market.
- Many more banks still haven't digested the toxic mortgages on their balance sheets and are facing new demands to pay off on bad mortgages they sold to Fannie and Freddie.
- The financial problems of these banks are straining their ability to lend to the small businesses that might otherwise be driving an economic recovery and reducing unemployment.
- And finally, it seems clear that Treasury's efforts to reduce mortgage foreclosures are not working.

As TARP's end date approaches, this Panel must know whether Treasury has carefully monitored the financial system to measure potential risks. We must also evaluate whether Treasury has diligently measured the impact of its efforts, using credible metrics to evaluate the success – or the failure – of its programs. Put another way: has Treasury administered TARP with the highest possible degree of transparency and accountability?

After all, reasonable people may approve or disapprove of your plan to stop foreclosures, but no one questions that its progress should be measured against a clear benchmark for success. Yet Treasury has provided no such benchmark.

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The point is blunt: Without more candid data on bank stability, commercial real estate, small business lending and home mortgage foreclosure efforts, the shape and depth of the risks facing our economy remain hidden. And without more willingness to separate programs that have worked from those that have not, it is not possible to build the best defenses.

The problems in commercial real estate, small business lending and home mortgage foreclosure grow more urgent by the day. In only three months your office will lose the capacity to substitute better programs for those that have failed or to develop new programs to deal with coming risks. I will be very glad to see TARP end. But I realize that time is running out to make certain that we have used this money to assure the stability of our financial system. Time is also running out to make certain that TARP money is used to help families and small businesses the way it was so quickly used to help Wall Street banks.

Before we proceed with the Secretary's testimony, I would like to offer my colleagues on the Panel an opportunity to make their own opening remarks.

STATEMENT OF J. MARK McWATTERS, MEMBER, CONGRESSIONAL OVERSIGHT PANEL

Mr. McWATTERS. Thank you, Professor Warren.

I very much appreciate the attendance of the Secretary and I look forward to hearing your testimony.

It is my hope that Secretary Geithner will assist the panel in addressing a number of interesting questions, including the following.

Is Treasury contemplating the allocation of additional TARP funds to any new programs or the allocation of additional TARP funds to any existing programs?

Is Treasury contemplating the allocation of TARP funds to any financial or nonfinancial institution, such as AIG, Citigroup, Chrysler, GM, or GMAC?

Will the taxpayers receive repayment in full—in cash—of their TARP investments in these institutions, as well as other TARP recipients?

What is Treasury's exit strategy with respect to these institutions, as well as the other TARP recipients?

Has TARP enshrined into our law the concept of "too big to fail"? In other words, has TARP established an implicit guarantee from the Federal Government for the benefit of our largest financial and nonfinancial institutions?

Will the pending financial reform legislation ratify and codify the implicit guarantee standard?

Would Treasury yet again allocate additional TARP funds to Goldman Sachs, AIG, Citigroup, Bank of America, and a group of other systemically significant firms if they notified Treasury today that they were experiencing a severe liquidity and solvency crisis?

How would the answer change if these institutions approached Treasury and the New York Fed after the pending financial reform legislation is enacted? Would the FDIC proceed to liquidate these institutions in an orderly and complete manner? And if so, are these institutions too interconnected with the global financial system to liquidate without triggering a cascade of unintended consequences?

Is this not what we were told in the last quarter of 2008 with respect to Goldman, AIG, Citi, Bank of America, among others, that certain institutions were simply too big to fail and as such could not under any circumstances be permitted to liquidate?

In such an event, is the resolution authority included in the pending financial reform legislation merely a modified TARP II bailout mechanism dressed up as resolution authority?

AIG was regulated by approximately 400 domestic and international regulators and they, along with Wall Street, Main Street, and most investment professionals completely missed the vast systemic risks that were percolating within AIG. How will the addition of one more regulator, a systemic regulator, proposed under the pending financial reform legislation help to solve this problem? Where do Treasury, the FDIC, the SEC, and the CFTC expect to find these all-omniscient, sage-like, super-regulators who are competent to cull out systemic risk that others have missed?

Even if the super-regulators timely identify such a risk, how will they convince Wall Street, Main Street, other regulators, the global financial community, and Congress that the risks are, indeed, legitimate and worthy of prompt action at great cost to the taxpayers and the financial community?

Why did former Federal Reserve Chair Volcker in an interview on CNBC, and as reported by the Huffington Post, state that the resolution authority provided in the proposed financial package is a "workable proposition for anything short of the biggest banks"? Does Chairman Volcker believe that it will be all but impossible to liquidate in an effective manner the "too big to fail" financial institutions during the next financial crisis? Does he believe that TARP II will be required?

Why did Treasury on June 11 issue a press release implying that the TARP program has been profitable? Even the Treasury itself expects the taxpayers to lose over $105 billion from their investments in the program, and the Congressional Budget Office expects the taxpayers to lose approximately $109 billion.

Why did Ed Whitacre, the CEO of General Motors, imply in a television commercial that GM has repaid all of its TARP funds even though the taxpayers have yet to receive repayment in cash for approximately $40 billion of TARP funds advanced to GM? And the Congressional Budget Office projects the taxpayers will lose approximately $34 billion of their TARP-funded investments in GM, Chrysler, and GMAC.

Thank you, Mr. Secretary, for joining us today. I look forward to our discussion.

[The prepared statement of Mr. McWatters follows:]

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Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of J. Mark McWatters

Congressional Oversight Panel Hearing with Treasury Secretary Timothy Geithner

June 22, 2010

Thank you Professor Warren.

I very much appreciate the attendance of Secretary Geithner and I look forward to hearing his testimony.

It is my hope that Secretary Geithner will assist the Panel in addressing a number of interesting questions, including the following:

- Is Treasury contemplating the allocation of available TARP funds to any *new* programs or the allocation of additional TARP funds to any *existing* programs?
- Is Treasury contemplating the allocation of TARP funds to any *financial* or *non-financial institution*, such as AIG, Citigroup, Chrysler, GM or GMAC?
- Will the taxpayers receive *repayment in full in cash* of their TARP investments in these institutions as well as the other TARP recipients?
- What is Treasury's current *exit strategy* with respect to these institutions as well as the other TARP recipients?
- Has TARP enshrined into our law the concept of "too-big-to-fail"? In other words, has TARP established an "implicit guarantee" from the Federal government for the benefit of our largest financial and non-financial institutions? Will the pending financial reform legislation ratify the implicit guarantee?
- Would Treasury yet again allocate additional TARP funds to Goldman Sachs, AIG, Citigroup, Bank of America and a group of other systemically significant firms if they notified Treasury *today* that they were experiencing a severe liquidity and solvency crisis? How would the answer change if these institutions approached Treasury or the New York Fed *after* the pending financial reform legislation is enacted? Would the FDIC simply proceed to *liquidate* these institutions in an orderly and complete manner and, if so, are these institutions too interconnected with the global financial system to liquidate without triggering a cascade of unintended consequences? Isn't this what we were told in the last quarter of 2008 with respect to Goldman Sachs, AIG, Citigroup, Bank of America, among others—that certain institutions were simply too-big-and-too-interconnected-to-fail and, as such, could not under any circumstances be permitted to liquidate. If such event, is the resolution authority included in the pending financial

reform legislation merely a modified *TARP 2* bailout mechanism dressed-up as resolution authority?

- AIG was regulated by approximately 400 domestic and international regulators and they, along with Wall Street, Main Street and most investment professionals, *completely missed* the vast systemic risks that were percolating within AIG. How will the addition of one more regulator—a systemic regulator proposed under the pending financial reform legislation— and a few more regulations help to solve the problem? Where do Treasury, the FDIC, the SEC and the CFTC expect to find these *all-omniscient, sage-like, super-regulators* who are competent to cull out systemic risks that others have missed? Even if the super-regulators timely identify such risks, how will they convince Wall Street, Main Street, other regulators, the global financial community and Congress that the risks are indeed legitimate and worthy of prompt action at great cost to the taxpayers and the financial community? What if in early 2006 a systemic regulator had concluded that subprime lending and securitized debt posed a threat to the global financial system? Who would have believed such analysis *at that time* and would the systemic regulator really have had the confidence and the competence to effectively persuade the members of the global financial community of the merits of its case?

- Why did former Federal Reserve Chair Volcker in an interview on CNBC and as reported by the *Huffington Post* state that the resolution authority provided in the proposed financial reform package is a "workable proposition for anything *short of these biggest banks*."[1] [Emphasis added.] The *Huffington Post* also reported that Professors Summers has stated that ending too-big-to-fail is the Administration's "central objective" and that resolution authority is the "most crucial" part of the plan. Does Chairman Volcker believe that it will be all but impossible to liquidate the too-big-to-fail financial institutions during the next financial crisis in an effective manner? Does he instead believe that TARP 2 will be required to rescue the institutions? Which of Professor Summers or Chairman Volcker is correct in his assessment of the effectiveness of the proposed financial reform legislation with respect to the too-big-to-fail financial institutions?

- Why did Treasury on June 11 issue a press release implying that the TARP program has been "profitable" even though Treasury itself expects the taxpayers to lose over $105 billion from their "investments" in the program and the Congressional Budget Office expects the taxpayers to lose approximately $109 billion?[2]

- Why did Ed Whitacre, the CEO of General Motors, imply in a television commercial that GM has repaid all of its TARP funds even though the taxpayers have yet to receive repayment *in cash* for approximately $40 billion of TARP funds advanced to GM, and

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[1] See "Volcker: New Government Powers Won't Be Able To Dismantle Megabanks; Too Big To Fail Lives Despite Reform Bill," *The Huffington Post*, June 15, 2010, at http://www.huffingtonpost.com/2010/06/15/volcker-new-government-po_n_612392.html.

[2] See "Treasury Department Announces TARP Milestone: Repayments to Taxpayers Surpass Tarp Funds Outstanding," U.S. Department of the Treasury, June 11, 2010, at http://www.treas.gov/press/releases/tg742.htm.

the Congressional Budget Office projects that the taxpayers will lose approximately $34 billion of their TARP funded "investments" in GM, Chrysler and GMAC?[3]

- When does the Administration plan to return Fannie Mae and Freddie Mac to the private sector? How does the Administration plan to accomplish this goal? On December 24, 2009 Treasury announced that it would provide *unlimited* support for Fannie and Freddie. How much money has Treasury allocated to Fannie and Freddie since the end of last year and to what purpose have the GSEs employed the funds? How much additional money does Treasury anticipate that it will allocate to Fannie and Freddie?

In addition, by a unanimously vote (4-0, with the recusal of Superintendent Neiman), the Panel recently issued a report on the taxpayer funded bailout of AIG.[4] I would welcome the Secretary's observations regarding the report including the following five conclusions reached by the Panel:

- The government failed to exhaust all options before initially committing $85 billion in taxpayer funds to the bailout of AIG.
- The rescue of AIG distorted the marketplace by transforming highly risky derivatives bets into fully guaranteed payment obligations.
- Throughout its rescue of AIG, the government failed to address perceived conflicts of interest.
- Even at this late stage, it remains unclear whether taxpayers will ever be repaid in full.
- The government's rescue of AIG continues to have a poisonous effect on the marketplace.

Also, by a unanimously vote (4-0, with the recusal of Mr. Silvers), three months ago the Panel issued a report on the taxpayer funded bailout of GMAC.[5] I would welcome the Secretary's observations regarding the report including the following three conclusions reached by the Panel:

- Treasury and the Federal Reserve made critical decisions during the height of the financial crisis that severely constrained their options for addressing GMAC's uncertain future.

[3] See youtube.com at http://www.youtube.com/watch?v=SSNPFVLIWjI.
[4] See "The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy," TARP Congressional Oversight Panel, June 10, 2010, at http://cop.senate.gov/documents/cop-061010-report.pdf.

See "Additional Views of J. Mark McWatters," June 10, 2010, at http://cop.senate.gov/documents/cop-061010-report-mcwatters.pdf.
[5] See "The Unique Treatment of GMAC Under the TARP," TARP Congressional Oversight Panel, March 10, 2010, at http://cop.senate.gov/documents/cop-031110-report.pdf.

See "Additional Views of J. Mark McWatters and Paul S. Atkins, March 10, 2010, at http://cop.senate.gov/documents/cop-031110-report-atkinsmcwatters.pdf.

- Treasury provided GMAC with TARP funds under the Auto Industry Financing Program, yet GMAC's bailout dollars also supported crippling losses in its mortgage lending business.
- Treasury has not required GMAC to lay out a clear path to viability or a strategy for fully repaying taxpayers.

Thank you Mr. Secretary for joining us today and I look forward to our discussion.

Chair WARREN. Thank you.
Deputy Chair Damon Silvers.

STATEMENT OF DAMON SILVERS, DEPUTY CHAIR, CONGRESSIONAL OVERSIGHT PANEL

Mr. SILVERS. Yes, good morning and thank you, Chair Warren.

Like my fellow panel members, I wish to express my great appreciation to Secretary Geithner for his willingness to appear before this panel on a regular basis to discuss the progress of the Treasury Department's efforts under the Emergency Economic Stabilization Act.

Today I think that the Treasury Department and Secretary Geithner deserve significant credit for the overall course of the performance of the assets the Government has acquired through TARP.

As my colleague, Mr. McWatters, has pointed out in a somewhat different tone, the cost of TARP continues to fall and is now estimated to be less than a third of what Treasury thought it would be a year ago. And while it is hard to know exactly how to understand the full costs of the financial bailout, combining TARP with other government interventions such as the activities of the Federal Reserve, the public should be aware that the real cost of TARP is not at this point $700 billion or even the $300 billion that it was thought to be a year ago, but rather something like $100 billion, and it is falling pretty consistently.

However, there remain three very significant questions that have been with us since the inception of TARP.

The first is, is TARP working to achieve its economic goals, reviving credit markets, stabilizing the financial system, and providing meaningful relief to homeowners facing foreclosure? Projections of long-term double-digit unemployment and continued high rates of foreclosure suggest we may not have really repaired our business credit system or our housing markets.

Second, are we continuing to manage TARP's assets effectively, particularly in relation to the most troubled of TARP's recipients and the riskiest aspects of the TARP portfolio. I am here particularly addressing AIG, Citigroup, and PPIP. I am recused from auto, so I am not raising that matter.

Third, are we taking to heart in the process of regulatory reform the lessons from TARP? As Congress' conference committee takes up the Wall Street Accountability Act of 2009, I am particularly mindful of the lessons of our panel's detailed examination of the collapse of AIG in our June report, the lessons for regulatory reform. That report on AIG is a powerful brief for the wisdom of keeping government-insured liabilities, whether that is insurance policies or bank deposits, away from highly risky assets such as derivatives and leveraged equities and for the need for a strong resolution authority for systemically significant institutions, a need which you, Mr. Secretary, have championed I think much to the public's benefit.

It is a challenge for this panel to evaluate TARP really against two different metrics, both of which are profoundly important.

One is TARP as literally a set of investments that the public has made in financial institutions and in certain other firms, evaluated against much the same metrics that any investment would be measured against.

The second is really the purpose of TARP, which was to ensure that the financial system did not take our economy down. We have moved, as our chair has noted, from an environment where the threat really was acute to, I believe, a situation where the threat from our financial system and the weaknesses in it is chronic. And that, I think, is really what I hope we can take up today, in addition to the other two subjects I mentioned a moment ago.

Again, my thanks to the Secretary for his agreeing to once again appear before us, and I look forward to his testimony.

[The prepared statement of Mr. Silvers follows:]

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Congress of the United States
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Damon A. Silvers

Congressional Oversight Panel Hearing with Treasury Secretary Timothy Geithner

June 22, 2010

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Second, are we managing TARP's assets effectively, particularly in relation to the most troubled of TARP's recipients and the riskiest aspects of the TARP portfolio. As I have asked to be recused from matters related to the auto company recipients, I am here addressing primarily AIG, Citigroup and PPIP.

Third, are we taking to heart in the process of regulatory reform the lessons from TARP. As Conference Committee takes up the Wall Street Accountability Act of 2009, I am particularly mindful of the lessons of our Panel's detailed examination of the collapse of AIG in our June report for regulatory reform. That report is a powerful brief for the wisdom of keeping government insured liabilities away from highly risky assets such as derivatives and leveraged equities and for the need for a strong resolution authority for systemically significant financial institutions.

I hope we can take up each of these subjects this morning. Again, my thanks to the Secretary for his agreeing to once again appear before us.

Chair WARREN. Thank you.
Dr. Troske.

STATEMENT OF KENNETH R. TROSKE, MEMBER, CONGRESSIONAL OVERSIGHT PANEL

Dr. TROSKE. Thank you, Chair Warren.

So I would like to start again, as the other panel members have done, by thanking Treasury Secretary Geithner for appearing before us today.

As the newest member of the panel, I have not gotten a chance to hear you testify before us, and I am looking forward to hearing your thoughts about the financial crisis we have just been through and what we can expect going forward.

In my opening statement today, I would like to focus on questions I still have about why financial markets in this country have not behaved as I believe they should have if they were truly a well functioning, competitive market. I have spent most of my professional life studying how markets function, but there are several aspects about these firms, these markets, and the recent financial crisis that I find both surprising and confusing. I would not have expected to see the events that we have seen if financial markets truly were well functioning, competitive markets.

While I have not been closely involved in studying this sector, you, Secretary Geithner, are someone who has played a key role in dealing with the financial crisis and also are trying to understand how to prevent a similar crisis from occurring in the future. I feel that one of the main purposes of the panel is to comment on the long-run implications of TARP and to comment on the effectiveness of TARP in minimizing the size of the financial crisis. So your insights are obviously valuable as we try to accomplish these goals.

One of the aspects of the financial sector I find confusing is the existence of systemically risky or "too big to fail" firms. The argument has been made repeatedly that the Government needed to step in and bail out firms such as AIG or Citigroup because the standard bankruptcy process is slow and disruptive and if these firms had been allowed to enter this process, it would have resulted in enormous disruptions in financial markets.

Of course, U.S. bankruptcy laws have been in existence for a long time, and numerous companies, both large and small, have entered bankruptcy in the past. So market participants should have been well aware of the difficulties large financial firms would have faced if they failed. Given this knowledge, as firms grew they should have faced increasingly higher costs of capital because of the increase in the cost of potential bankruptcy risk. By imposing higher capital costs on large companies, the market would have placed a limit on the size of financial firms below the "too big to fail" threshold.

Instead, it appears as if these large financial firms faced lower costs for both debt and equity than smaller financial firms. This allowed these firms to borrow enormous sums of money which they then used to purchase a variety of increasingly risky assets, and an upward cycle of growth, access to cheaper capital allowed these firms to grow even larger and break the "too big to fail" barrier. In a well functioning market, this should not have occurred.

Another aspect of the financial crisis that I find surprising is that while the market was sending clear signals that the residential mortgage-backed securities were risky, traders purchasing these assets seemed to simply ignore these signals. Basic financial theory teaches us that in order to earn an above-market return, one needs to purchase an asset with above-average risk. This is simply a formulization of the age-old adage that economists often use, "there is no such thing as a free lunch," which in turn is the formulation of something mothers tell their children, "if something seems to be too good to be true, it is."

Unfortunately, participants in mortgage-backed security markets ignored what they were taught in econ 101 and what their mothers warned them about. Since these securities were earning an above-market return based on the level of perceived risk, people who were purchasing them should have realized that the historic returns were not supportable despite what they were being told by credit rating agencies. Over time, people learned that these assets were quite risky. The efficient market hypothesis worked vigorously and many of these assets are now worth much less than what was paid for them.

In addition, managers seemed to have done an extremely poor job assessing the riskiness of the assets they purchased. Yet, few managers have been penalized for their poor performance. These financial companies were essentially purchasing boxes filled with residential mortgages. These boxes were stamped on the cover by one of the rating agencies. Managers then chose a combination of boxes to buy, depending on the overall risk they wanted to achieve. They threw these boxes in the corner and just waited to cash dividend payments produced by these boxes to arrive. It does not appear that they ever opened any boxes to check to see whether what was stamped on the cover was an accurate reflection of what was inside. Additionally, it does not seem that they ever tried to assess the covariance between boxes which is key for understanding the amount of risk faced by their firms.

In other sectors, these managers would be out of a job. In the financial sector, they seem to still be working. This is hard to understand.

This all leads me to conclude that the financial sector is simply not a well functioning, competitive market, and I am trying to understand why.

One of the things I think we need to consider is that part of the problem is that the Government has long backed up creditors and insured them at 100 cents on the dollar. This has then led creditors to be willing to lend money to these financial institutions at a below-market rate.

[The prepared statement of Dr. Troske follows:]

ELIZABETH WARREN, CHAIR
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CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Kenneth Troske

Congressional Oversight Panel Hearing with Treasury Secretary Timothy Geithner

June 22, 2010

Thank you Professor Warren.

I would like to start by thanking Treasury Secretary Geithner for appearing before us today. As the newest member of the panel I have not gotten a chance to hear you testify before and I am looking forward to hearing your thoughts about the financial crisis we have just been through and what we can expect going forward.

In my opening statement today I will focus on question I still have about why financial markets in this country have not behaved as I believe they should have if they were operating in well functioning competitive market. I have spent most of my professional life studying how markets functions, but there are several aspects about these firms, these markets, and the recent financial crisis that I find both surprising and confusing. I would not have expected to see the events that we have if the financial market was a well functioning competitive market. While I have not been closely involved in studying this sector, you, Secretary Geithner, are someone who has played a key role in dealing with this financial crisis, and have tried to understand how to prevent another similar crisis from occurring in the future. I feel that the main purpose of the Panel is to comment on the long run implications of the TARP and to comment on the effectiveness of TARP in minimizing the size of the financial crisis, and your insights are obviously valuable as we try to accomplish these goals.

One of the aspects of the financial sector I find confusing is the existence of systemically risky, or too big to fail, firms. The argument had been made repeatedly that the government needed to step in and bail out firms such as AIG or Citi because the standard bankruptcy process is slow and disruptive, and if these firms had been allowed to enter this process, it would have resulted in an enormous disruption in financial markets. Of course, U.S. bankruptcy laws have been in existence for a long time and numerous companies both large and small have entered bankruptcy in the past, so market participants should have been well aware of the difficulties large financial firms would face if they failed. Given this knowledge, as firms grew, they should have faced increasingly higher cost of capital because of the increase in the cost of potential bankruptcy risk. By imposing higher capital costs on large companies the market would have placed a limit on the size on financial firms below the too big to fail threshold. Instead, it appears as if these large financial firms faced lower costs for both debt and equity than smaller financial firms. This allowed these firms to borrow enormous sums of money, which they then used to purchase a variety of increasingly riskier assets. In an upward cycle of growth, access to cheaper capital allowed these firms to grow even larger and break the too big to fail barrier. In a well functioning market, this should not have occurred.

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Another aspect of the financial crisis that I find surprising is that while the market was sending clear signals that the residential mortgage backed securities were risky, traders purchasing these assets seemed to simply ignore these signals. Basic finance theory teaches us that in order to earn an above market return one needs to purchase an asset with above average risk. This is simply a formalization of the age-old adage that economists often use, "there is no such thing as a free lunch," which in turn is a formalization of something mothers tell their children, "if something seems too good to be true, it is." Unfortunately, participants in mortgage backed securities markets ignored what they were taught in Econ 101 and what their mothers warned them about. Since these securities were earning an above market return based on the level of perceived risk, people who were purchasing them should have realized that the historical returns were not supportable, despite what they were being told by credit rating agencies. Over time, people learned that these assets were quite risky; the efficient market hypothesis worked vigorously, and many of these assets are now worth much less than what was paid for them.

By borrowing funds at relatively low rates and then investing in these risky assets, managers at financial firms were able to earn substantial bonuses and amass large fortunes. The problem appears to be that neither equity nor bond holders ever questioned the behavior of the managers of these firms. And while it may be easy to understand why equity holders were willing to play along—they were also receiving an above average return—it is much harder to understand why bond holders did not more carefully scrutinize the behavior of management since bond holders did not receive any of the return from this additional risk. In well functioning competitive markets, the role for bond holders would be to recognize that the returns the firms were receiving from the assets were greater than implied by the nature of the assets and to question the underlying characteristics and risk of the assets.

Finally, managers seemed to have done an extremely poor job assessing the riskiness of the assets they purchased, yet few managers have been penalized for their poor performance. These financial companies were essentially purchasing boxes filled with residential mortgages. These boxes were stamped on the cover by one of the rating agencies. Managers then choose some combinations of boxes to buy—some AAA boxes, a few A boxes, a couple of BB boxes—depending on the overall risk they wanted to achieve, and then they threw these boxes in the corner and just waited on the cash dividend payments produced by these boxes to arrive. It does not appear that they ever opened any of the boxes to check to see whether what was stamped on the cover was an accurate reflection of what was inside. Additionally, it does not seem that they ever tried to assess to covariance between the boxes, which is key for understanding the amount of risk faced by their firm. In other industries, managers who behaved in such a reckless fashion would find themselves out of a job. However, in the financial sector, while some managers did lose money (and a few lost quite a bit of money) many of them remain quite wealthy and continue to work in the sector. This is hard to understand.

All of this leads me to conclude that the financial sector is simply not a well functioning competitive market, and I am trying to understand why. One possibility that we need to consider is that the cause of this recent crisis is the result of how the government has dealt with past financial crises such as the failure of Continental Illinois Bank in 1984 and the more recent failure of Long Term Capital Management. In these crises, the government worked out rescue plans or bailouts that resulted in creditors always receiving 100 cents on the dollar. Given this behavior by the government, it seems reasonable that creditors began to expect that the government would always be able to work out a plan to rescue large financial firms that experience difficulties in a way that insures the creditors against losing money. As Nobel prize winning economist Joseph Stiglitz and many others have described it, we have privatized profits but socialized losses. Given this implicit insurance, creditors are incentivized to lend to large firms at low interest rates which eventually produces a firm that is too big to fail.

A large part of the problem is that in the midst of a financial crisis it is difficult, if not impossible, to suddenly change the rules of the game and begin to impose market discipline on firms. Instead, when a number of firms are struggling simultaneously, governments feel that they must step into the market and bailout the large systemically risky struggling firms or arrange mergers between some failing firms and some of the relatively healthier firms. Unfortunately, these actions produce a more concentrated and less competitive financial sector with even larger (or much too big to fail) firms. In turn, this increases the likelihood that we will suffer more, and more complicated, financial crises in the future. In the end, it should not be surprising that taxpayers have become frustrated with the fact that they are continually asked to provide very valuable insurance, at no cost to the wealthy individuals who benefit, and that this situation appears to get worse over time. To taxpayers TARP appears to be simply another taxpayer financed rescue of large financial firms that has occurred several times in the past, and their frustration with TARP seems to me to indicate that they are simply tired of insuring the losses of these firms.

Given your central role in orchestrating the government's response to the recent financial crisis, I am interested in hearing your thoughts on these issues as well as your responses to the questions the other members of this Panel have raised. Thank you again for your testimony today.

Chair WARREN. Thank you, Dr. Troske.

Superintendent Neiman.

STATEMENT OF RICHARD H. NEIMAN, MEMBER, CONGRESSIONAL OVERSIGHT PANEL

Mr. NEIMAN. Thank you.

Mr. Secretary, thank you for being here again to speak with the panel and to the public about important issues impacting financial stability and economic recovery.

It has been over a year since our first hearing with you in April '09, so it is perhaps fitting to briefly take stock of where we stand in comparison to that period in history.

First, it goes without saying that progress has been made in restoring financial stability. Although difficult challenges remain, the crisis levels of last year have receded and capital markets are beginning to function more normally.

Second, a significant amount of TARP funds have been successfully repaid. This is an impressive accomplishment, as many banks have been able to privately raise capital and increase earnings in a market that is still constrained by recession.

Finally, many of the causes of the financial crisis that put American taxpayers on the hook in the first place are being addressed in Congress as we speak.

However, in other areas, needed change has not come as quickly as desired over the past year. And unfortunately, these are some of the very areas where Americans are hit the hardest. I may now be the panel's virtual broken record on foreclosure prevention, but it is critical that families at risk of losing their homes have options that work. I am particularly concerned with yesterday's Treasury HAMP report indicating that there are now far more families whose HAMP trial modifications have been canceled than there are families whose trial modifications have been converted to long term.

Further, I think we all agree that small business lending is key to entrepreneurship and job creation. Yet, we continue to hear that viable small businesses are unable to access the credit they need. This was a recurrent theme from witnesses in our recent hearing in Phoenix. I am encouraged that the House recently approved the creation of the administration's proposed small business lending fund. The fund would provide capital to the community and regional banks that are at the heart of small business lending. I would like to explore small business credit access and other lending issues with you this morning.

Finally, with the financial reform work near completion, the United States finds itself in a unique and, some critics say, precarious position. Our country is doing our part in setting an example as a world financial leader. But as you are more aware than anyone, there are challenges we face within the global community between balancing our role as a leader of financial reform with the future of our international competitiveness. Time permitting, I would like to discuss this challenge with you so the public can more fully gain your perspective on moving our Nation toward reform while at the same time strengthening our position in a global economy.

I look forward to your views.

[The prepared statement of Mr. Neiman follows:]

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Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Richard H. Neiman

Congressional Oversight Panel Hearing
with Treasury Secretary Timothy Geithner

June 22, 2010

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I look forward to your views.

Chair WARREN. Thank you, Superintendent Neiman.

Secretary Geithner, I would like to recognize you for five minutes. Of course, your written statement will be part of the record. We will try to hold it to five minutes so there is plenty of time for our questions and answers. Secretary Geithner.

STATEMENT OF TIMOTHY F. GEITHNER, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary GEITHNER. Thank you, Chair Warren and members of the panel. A pleasure to be back up here again to review progress and our challenges ahead.

You know, as you know in the fall of 2008, as we confronted the worst financial crisis this country has seen in more than 70 years, Congress and the previous administration mobilized an extraordinary financial response. Their actions started the process of stabilizing a financial system that was on the verge of collapse, and when President Obama came into office, he took the necessary steps to start to finish that job, to start to save the economy from what could have been a second Great Depression.

Now, last December, I outlined for this panel an exit strategy for the Government's emergency programs. This morning I just want to update you briefly on the impact those programs have had on our recovery, on the progress we have made in shutting them down, and their ultimate cost.

First, because of the actions we took to put out the financial fire, alongside actions of the Federal Reserve and the Recovery Act, the economy is growing again, exports are rising, manufacturing output is on the rebound, businesses are investing, and so far this year, the economy has created half a million jobs in the private sector.

Because of our actions, the financial system is in a much stronger position, and because of that, the cost of credit for homeowners, for consumers, for businesses has fallen significantly. Rates for conventional mortgages and auto loans, for example, are at historic lows. By acting quickly and with overwhelming force, we were able to avoid a much deeper recession, a much more costly recession.

Second, we are now in the process of ending our emergency programs and recouping our investments. As you know, we have shut down most of the programs that characterized that initial phase of the emergency response, the capital purchase program, Treasury's emergency guarantee for money markets, and the Federal Reserve has wound down the vast majority of its special lending programs. All those programs are on track to generate a significant profit for the taxpayer.

We are making significant progress getting the taxpayers' money back. To date, more than half of all the money disbursed through the TARP has been repaid. TARP investments have generated $24 billion in additional revenue for taxpayers. When President Obama took office, nearly $240 billion of TARP funds had been invested by the previous administration into our Nation's banking system. Today we have recovered three-quarters of that money, and we are making progress getting out of AIG and out of GM and Chrysler.

Third, as many of you have pointed out, the expected overall cost of TARP continues to fall. Last August, we projected potential losses at $340 billion. Today that estimate is down to $105 billion. We view that as a conservative estimate. We expect it to fall further. And as you know, the President has proposed a financial crisis responsibility fee to make sure that the Nation's largest institutions that benefited most from these programs bear the cost of any ultimate losses on this program. That way we will be able to say to the American people they did not have to pay a penny of their hard-earned dollars to cover the losses that we may still face in TARP.

We are on track to shut this program down as scheduled, and we expect to do so without having used hundreds of billions of dollars in authority that Congress gave us initially. To say it differently, we are going to return hundreds of billions of dollars of authority unused to the Congress to devote to reducing our future deficits and meeting the long-term needs of the country.

Now, as you said, we all look forward to the day when these programs are history. It is important to recognize, though, they did what they were supposed to do. There is no job growth without economic growth, no economic growth without access to credit, no access to credit without a stable, functioning financial system. And our emergency programs played an essential role in starting that process of recovery and repair.

Now, the damage caused by this crisis is still affecting the lives of millions of American families and thousands of businesses across the country, those struggling to find a job still, to make a mortgage payment, finance their retirement or their kids' education, or the small business owner who still cannot find access to credit on affordable terms.

And that is why in these final months, we will commit to use TARP authority—continue to use that authority to promote and maintain stability in the housing market and to improve access to credit for families and small businesses. That is why we are working with Congress and I think are quite close to getting Congress to adopt a new small business lending facility to help meet the needs of small business on the credit side, and that is why, of course, we are urging the Congress to act quickly to enact financial reform.

We are not prepared to leave future generations of Americans vulnerable to the devastating effects of the financial crisis, and they should never again have to be asked to bail out a financial system in crisis.

The House and the Senate are now very close—I am wrapping up—very close to enacting the strongest set of reforms we have considered as a country since the Great Depression. I would be happy to talk about those in more detail, but it is now time to provide the clarity and certainty about what the new rules of the road will be. Doing so will help recovery, help strengthen growth, help make sure that this financial system does a better job in the future of meeting the needs of Main Street businesses and families, and it will help restore confidence that our financial system will be a source of stability, not instability, for the U.S. economy and the global economy in the future.

You began with excellent questions. I will be happy to spend some time with you walking through the challenges ahead.

[The prepared statement of Secretary Geithner follows:]

EMBARGOED UNTIL DELIVERY

Secretary of the Treasury Timothy F. Geithner
Written Testimony
Congressional Oversight Panel
June 22, 2010

INTRODUCTION

Chair Warren and members McWatters, Neiman, Silvers, and Troske, thank you for the opportunity to testify about government policies to address the financial crisis, in particular the role of the Troubled Asset Relief Program (TARP).

Our economy is still going through an incredibly difficult period. Millions of Americans are still looking for work and are suffering from the damage of a deep recession. The impact of this crisis will be lasting.

But the actions the government took have helped stabilize the financial system and restore economic growth. Many of these actions were unpopular. However, they were essential. And they have put our economy in a much stronger position to confront the challenges that lie ahead.

Financial policies have lowered borrowing costs for homeowners, consumers, businesses, and state and local governments. They have supported small and community banks that have expanded lending to small businesses during the recession. They continue to help responsible, but at-risk Americans hold onto their homes and to repair essential channels of new credit.

TARP has been critical to this progress, and it has helped restore financial stability at a much lower cost than anticipated. We have already recovered more than half of total disbursements under the program. And TARP investments have generated $24 billion in additional revenue for taxpayers.

Authority to make new commitments through TARP will expire in October, and we are well on our way to winding down the program. We will continue to manage remaining investments in a way that protects taxpayers and supports our financial and economic recovery.

IMPACT OF GOVERNMENT FINANCIAL POLICIES ON THE U.S. FINANCIAL SYSTEM

Since this Administration took office, Government policies have substantially improved the availability of credit in the United States.

Emergency programs helped lower borrowing costs for U.S. homeowners, consumers, and businesses by rebuilding confidence in our financial system. Rates for conventional mortgages and auto loans are at historic lows. Municipal bond rates have fallen to pre-crisis levels. The cost of commercial and industrial loans that many small businesses rely heavily upon is lower than it was going into the crisis. And banks appear to have finished tightening credit standards for both large and small borrowers.

The U.S. banking system is stronger today. TARP provided a critical backstop for the stress tests of our major banks, which provided transparency and forced them to raise over $150 billion in capital from private sources. Delinquencies for many loan categories appear to have peaked.

The cost to insure against the risk of default of banks is less than half of what it was last March. That translates into lower loan rates for consumers and businesses.

TARP and other government and Federal Reserve programs have also helped to rehabilitate markets that support consumer and small business credit.

After experiencing steep declines between 2006 and early 2009, home prices are showing signs of stabilization. Inventories of homes for sale have fallen, millions of homeowners have refinanced at low rates, and TARP continues to help responsible, but struggling families stay in their homes.

Corporations continue to raise substantial capital in private markets and have built up record cash reserves, which will eventually be reinvested and fuel growth.

While substantial progress has been made, significant challenges remain. In the banking system, charge-offs for residential, consumer, and commercial loans are still elevated, and the FDIC projects that the rate of bank failures will remain high.

Despite offering relatively low borrowing costs, banks continue to report falling loan balances. To a significant degree, this reflects a natural and healthy adjustment as borrowers and lenders de-leverage after a period of aggressive credit expansion. But it does mean that many consumers and businesses are still finding it difficult to get new credit.

Nevertheless, thanks to the coordinated and forceful actions of Congress, the Obama Administration, the Federal Reserve, the FDIC, and other regulatory agencies, the U.S. financial system is much stronger today than it was in early 2009. Credit conditions overall, which dragged our economy into a deep recession in 2007, no longer pose an obstacle to growth. TARP played a critical role in achieving that outcome.

EXITING EMERGENCY FINANCIAL PROGRAMS AND REPAYING TAXPAYERS

Our progress to date in stabilizing the financial system, bringing down the cost of credit, and opening up capital markets has enabled us to wind down and terminate many of the programs put in place to address the crisis. Programs that we have terminated include: Treasury's Money Market Fund Guarantee Program; the debt guarantee component of the FDIC's Temporary Liquidity Guarantee Program (TLGP); the majority of the Federal Reserve's special lending programs; and the Treasury and Federal Reserve mortgage-backed security purchase programs.

We are well on the way to winding down TARP.

We closed the Capital Purchase Program, under which the bulk of support to banks has been provided. To date, banks have repaid approximately 75 percent of TARP funds they received, and TARP investments in banks have generated taxpayers $21 billion in income from dividends, sales of warrants and stock, and fees from cancelled guarantees. We expect TARP investments in banks to generate a positive return on the whole.

We have begun to sell our holdings of Citigroup common stock. In April and May, we sold roughly 20 percent of our stake, for proceeds totaling $6.2 billion, which is $1.3 billion above our cost. We are in the process of selling another 1.5 billion shares, and we plan to liquidate the remainder of our stake in an orderly fashion by the end of this year.

AIG is making progress in restructuring its operations, in order to repay taxpayers and reduce its risk to our economy. The company is winding down its Financial Products subsidiary, where much of that risk was concentrated. The company is working to divest two of its largest foreign insurance subsidiaries, and the proceeds will be used to pay down its loan from the Federal Reserve. And AIG's core businesses are generating profits. However, TARP investments in AIG will likely still result in some loss.

The auto industry has also undergone significant restructuring, and its prospects for repaying government investments have improved. GM sales are 18 percent higher than they were last May, while Chrysler sales have increased 33 percent. Chrysler Financial has repaid (with interest) the $1.5 billion loan that it received. GM recently repaid its TARP loans in full (with interest), and Treasury plans to begin to recover its equity investments in the company when GM launches an initial public offering later this year or in 2011. We also expect that losses from our investments in GMAC will be less than were forecast last year.

As a result of improved financial conditions and careful stewardship, the expected cost of TARP continues to fall. In August 2009, we projected that TARP would increase Federal deficits by $341 billion. Today, that number is down to $105 billion,[1] which we view as a conservative estimate. And the President has proposed a Financial Crisis Responsibility Fee that will recoup those costs from the riskiest parts of our financial system.

BROADENING THE SCOPE OF THE FINANCIAL RECOVERY

While we are winding down TARP and other emergency programs, government policies continue to play an important role in repairing the damage to our financial system, preserving stability, and broadening the scope of the financial recovery for all Americans.

Through TARP and other policies, we are working to promote and maintain stability in housing markets, and to mitigate foreclosure for responsible but at-risk homeowners. Currently, over 800,000 homeowners are benefiting from lower monthly payments in permanent or trial mortgage modifications through the Making Home Affordable program. This year we expanded that program to offer principal reduction relief for borrowers, many of whose mortgages are deeply underwater. We have also committed over $2 billion in TARP funds for programs coordinated by housing agencies in states that have suffered severe home price declines and high concentrations of unemployment. We are announcing this week our approval of the first round of disbursements through this "Hardest-Hit Fund."

These TARP-funded programs reinforce other government policies that have helped promote stability, including the first-time homebuyer tax credit and Neighborhood Stabilization grants

[1] Treasury's Office of Financial Stability recently published updated cost estimates of TARP using publicly available data as through March 31, 2010. *See* http://www.treas.gov/press/releases/tg713.htm. The $105 billion estimate reflects projected program cost over its life, including interest on re-estimates and excluding administrative costs. This is $11.4 billion lower than what was reported in the FY2011 Budget, because of a higher projected return on Treasury's holdings of Citigroup common stock and lower projected losses on investments in AIG and the auto industry. The estimates in the FY2011 Budget were based on valuations through November 30, 2009.

under the Recovery Act. Treasury's support for the government-sponsored enterprises (GSEs) and purchases of their securities by Treasury and the Federal Reserve have facilitated most new mortgage issuance in this country and kept mortgage rates at historical lows for borrowers.

We are also using TARP to improve credit availability for small businesses. Earlier this year, we began purchasing securities backed by SBA-guaranteed loans. Announcements in early 2009 related to this purchase program and the Term Asset-Backed Securities Loan Facility (TALF) helped restart securitization markets for small business loans last year. In February, we launched a new program to invest in Community Development Financial Institutions (CDFIs)—including qualifying credit unions—which lend to small businesses in our country's hardest-hit communities. Candidates have submitted applications to their primary regulators, and Treasury has begun to receive applications and expects to begin funding by next month.

In addition, we are seeking legislation to create a new $30 billion Small Business Lending Fund outside of TARP that would provide small and community banks with new capital and incentives to increase small business lending. We have also proposed a State Small Business Credit Initiative to strengthen innovative state programs, many of which have been threatened by state budget cuts. This Panel has suggested that such a measure could be an effective complement to Treasury's other efforts to support small business lending. Last week, we were pleased to see the House pass legislation that included these proposals as well as key small business tax cuts, and we encourage the Senate to move quickly to pass these measures.

TALF and the Public-Private Investment Program (PPIP) have contributed to a recovery in security prices and facilitated new credit for consumers and businesses. Scheduled to terminate at the end of this month, TALF has supported $58 billion of asset-backed securities, along with $12 billion of securitization for commercial mortgages. Using a combination of TARP and private capital, Public-Private Investment Funds have purchased, to date, $12 billion of securities from banks. PPIP has also had a significant impact on prices for legacy assets that had contributed to the credit crunch. Prices for some of the most distressed securities backed by residential mortgages have increased 70 percent since last March, while prices for some securities backed by commercial properties have improved by roughly half over the same period.

FINANCIAL REFORM IS CRITICAL TO SUSTAINING THE RECOVERY

The success of the government programs to stabilize our financial system allows us now to shift focus from crisis response to crisis prevention.

Congress is close to passing comprehensive reforms that will make our financial institutions and markets safer. The new law will create an independent consumer financial protection agency, whose mission will be to promote transparency and consumer choice, and to prevent abusive and deceptive practices. These reforms will require stronger capital and liquidity requirements for banks and other financial companies, allowing them to absorb future shocks without relying on government support. The reforms will end "too big to fail." Non-bank financial firms, such as AIG, will no longer be allowed to exploit regulatory cracks. Large, interconnected financial companies will be subject to stricter requirements. And derivatives will be subject to strong regulation and transparency. The federal government will have the authority to close large failing financial firms in an orderly and fair way, without putting taxpayers and the economy at risk.

THE END OF TARP

Like this Panel and most of the American public, I look forward to the day when TARP is no longer needed and taxpayers have recovered every dollar invested through it. On October 3, 2010, we will cease making new commitments through the program. And as we exit from remaining TARP investments, we will adhere to the following principles.

- We will dispose of investments as soon as practicable in order to return TARP funds and reduce the federal debt.
- We will do so in an orderly manner that minimizes the impact on financial markets and the economy, while protecting taxpayer investments.
- Wherever possible, we will encourage private capital formation to replace government investments.
- We will not intervene in the day-to-day management of private companies in which we have invested.
- And, as we implement this strategy, we will seek out the best advice available.

When TARP was created, a broadening financial panic threatened the jobs and financial security of millions of Americans. Today, the economy is growing again, jobs are starting to come back, and families' savings are more secure. This turnaround would not have been possible without substantial commitments to both fiscal stimulus and financial stability. This Administration's integrated strategy to recapitalize the banks with private capital, and to support the securities markets which are critical to lending, implemented through TARP, was critical to the overall success of our economic program.

In evaluating TARP's contribution to financial stabilization and economic recovery, it is important to recognize that investments under the program have been far smaller than commonly recognized. Before President Obama came into office, Congress wisely gave Treasury the authority to commit up to $700 billion dollars under TARP to stabilize the financial system. To date, $386 billion has been disbursed under the program, and over half of that amount has been repaid. Most large banks have already repaid all TARP funds they received, with billions of dollars in profit for taxpayers. The ultimate cost of the program will likely be a fraction of the $700 billion authorized by Congress. Soon, we will return hundreds of billions of dollars in unused TARP authority to limit future debt, and to free up additional resources to meet the long-term needs of our country.

Figure 1. TARP Disbursements, Repayments, and Income as of June 21, 2010 (US$, billions)

	Disbursed [1]	Repayments [1]	Outstanding Funds [1,2]	*Income* [1,3]
Existing Programs				
Capital Purchase Program	205	142	63	*17*
Targeted Investment Program (Citi, BofA) [4]	40	40	0	*4*
Special Assistance for AIG	48	0	48	*0*
Automotive Industry Financing Program	80	11	69	*2*
Asset Guarantee Program [4]	0	0	0	*1*
Term Asset-Backed Securities Loan Facility	0	0	0	*0*
Public-Private Investment Program	12	0	11	*0*
Home Affordable Modification Program [5]	1	0	1	*0*
Total	**386**	**194**	**192**	***24***

[1] Estimates may not sum to total due to rounding.
[2] Disbursements minus repayments.
[3] Includes revenue from dividends, sales of warrants and stock, and fees from cancelled guarantees.
[4] Terminated. Treasury and the FDIC retained $5.2 billion (face value) of Citigroup Trust Preferred Securities, as well as warrants, when the Asset Guaranteed Program was terminated. Treasury also received $276 million from Bank of America when it terminated its participation in the program.
[5] Includes $1.244 billion in disbursements for the Helping Families Save Their Home Act of 2009.

Source: Treasury.

Figure 2. TARP Commitments as of June 21, 2010 (US$, billions)

	Commitments Pre-Jan. 20 [1]	Commitments Jan. 20 - Present [1]	Repayments and Cancelled Commitments [1]	Outstanding Commitments [1,2]	Anticipated Future Commitments [1]
Capital Purchase Program [3]	194	11	142	63	0
Targeted Investment Program (Citi, BofA) [4]	40	0	40	0	0
Special Assistance for AIG	40	30	0	70	0
Automotive Industry Financing Program	21	64	11	74	0
Asset Guarantee Program [4]	5	0	5	0	0
Consumer & Business Lending Initiative	0	20	0	20	32 [5]
Public-Private Investment Program	0	30	0	30	0
Home Affordable Modification Program [6]	0	41	0	41	9
Total	**300**	**196**	**199**	**297**	**41**

[1] Estimates may not sum to total due to rounding.
[2] Legally binding commitments minus repayments and cancelled commitments.
[3] Commitments since January 20, 2009, include $7 billion for banks and $4 billion for insurance companies Hartford Financial Services Group and Lincoln National Corporation.
[4] Terminated.
[5] While $30B has been reserved for a small business lending program, the Administration has proposed creating a $30B Small Business Lending Fund separate from TARP through legislation. Not more than $1 billion is planned for SBA 7(a) purchases and not more than $1B is planned for the Community Development Capital Initiative (CDCI).
[6] Includes $1.244 billion in commitments and disbursements for the Helping Families Save Their Home Act of 2009.

Source: Treasury.

Chair WARREN. Thank you very much, Mr. Secretary.

I think your point about the accomplishments of TARP are quite significant and your emphasis on the importance of a stable, functional financial system is what I would like to talk about. We have, obviously, made enormous progress in that direction, but part of oversight is looking where the problems still lie. I do not have to remind you that in just over three months, Treasury will no longer be able to initiate or redesign programs under TARP. What we do not do now we cannot do in the future. So we need to make sure that we have a good assessment of the problems that lie ahead and whether our proposed solutions are working.

So I wanted to start with small banks. This panel has written about the coming troubles in commercial real estate. About half of the 1.4 trillion in commercial real estate loans held by banks will be underwater by the end of this year, which will make refinancing almost impossible for tens of billions of dollars of loans. About 3,000 of the 8,000 intermediate and small banks have lending portfolios that are heavily concentrated in commercial real estate. We estimate that banks could be facing $200 billion to $300 billion in losses on these loans.

So, on the current course, that means that hundreds, or even thousands, more small banks could capsize. What is Treasury doing now to prepare for these coming problems? Do we need to be reworking any of our current programs, Mr. Secretary?

Secretary GEITHNER. Excellent question. And you are right to emphasize, as I tried to do, that we are going to be living for a long time with the lasting effects of this crisis. The damage was extraordinary. It reached far and broad across the American economy, and if you were in the real estate business, if you were in parts of the country that have exceptionally high unemployment rates, if you ran your business on access to credit that got washed out in this basic crisis, it is still an enormously challenging environment.

And as you are right to point out, the small banks too came into this crisis, many much more conservatively managed than their Wall Street competitors, but many of them got themselves in a position where they had exceptionally high, regrettably high, unacceptably high levels of exposure to commercial real estate, and they still face a very difficult process of adjustment ahead.

We have a set of programs still in place. The fuse on those programs will last beyond the formal expiry of TARP because as TARP was designed, we still preserve the capacity to implement those programs after the formal expiry of TARP.

My view is the most effective thing we can do for the credit problems still ahead in the economy and the challenges still facing small businesses, small banks, because of the pressures on small businesses, is for Congress to enact this set of credit programs for small businesses.

The way these programs are designed—and it is worth spending a minute on this—they do two very important things. One is they provide a modest amount of additional resources to States across the country that have programs in place to help provide support to small banks and small businesses. But alongside that, we propose a new small business lending facility that small banks will be able to access by coming to apply for investments from the Government, and the more they increase lending, the lower the rate they pay on those investments.

Chair WARREN. Mr. Secretary, if I could just stop you there to emphasize a different part of the question. And I understand the reasons for supporting this when we talk about small business lending.

But the question right now is that 3,000 of our 8,000 banks across the country have heavy concentrations in commercial real estate. As I read it, for example, the new initiatives on small business lending, that is money that is not designed to go into banks to help them repair broken balance sheets. It is money to go into the healthy banks, the ones presumably that do not face the serious problems associated with their commercial lending portfolios.

So the question I want to ask and that I want to press on is when you talk about the stability of the American banking system, we have 3,000 banks at serious risk that may not survive. What is Treasury doing about that? Or is the answer we are going to let them go?

Secretary GEITHNER. As you know, Chair Warren, I cannot associate myself with your basic numbers about the magnitude of problems. That is an issue where really the FDIC's basic framework is probably the most reliable reference we have. I do not know what their numbers are, but——

Chair WARREN. I am sorry, Mr. Secretary. Just so we are all clear on this, the numbers about concentrations of commercial real estate come from the banks' examiners. Those are not numbers we generated. They have been generated by those who examine their books on a quarterly basis.

Secretary GEITHNER. I am agreeing with you about the challenges. I just did not want my agreement with you about the challenges——

Chair WARREN. Fair enough.

Secretary GEITHNER [continuing]. To be associated with your numbers on the picture because that I want to rely on the supervisors to paint that picture.

As you know, we have a very elaborate process, well designed across this country that our supervisors run with the FDIC for dealing with the challenges facing our Nation of 9,000 community banks and thrifts. That process was designed in the wake of a series of past crises. It is a very well designed process, in many ways the envy of the world, and that gives the Government the ability to help those banks manage through, but also for making sure that we can help facilitate the restructuring ahead for that system.

Now, those banks who are under pressure have lots of options. They can go raise capital. They can shrink lending to bolster their balance sheet positions. And you are also right to point out that the programs we designed from the beginning for very important reasons are only available for banks that we believe would be viable as an approach. But these are very important programs because what they will help do is make sure the banks face less need to shrink their balance sheets and have more capacity to expand their lending to businesses. So they could be very helpful as a complement to the basic programs that the FDIC and the bank supervisors run.

Chair WARREN. So I am over and I am going to take this off my time on the next question, but I just want to make sure. What I am hearing you say is, no reason to change anything. We will stay steady on the same course.

Secretary GEITHNER. Well, you know, I am a very careful person and a very pragmatic person, and I am open to any ideas for how to make sure we are using our authority appropriately to help the country still manage through the challenges ahead.

But at this stage, I believe that this suite of programs we have in TARP, alongside the existing programs that the FDIC and the supervisors manage, with this new small business lending initiative the Congress is considering, is the best mix of solutions that we have found at the moment.

Chair WARREN. Thank you, Mr. Secretary.

Mr. McWatters.

Mr. MCWATTERS. Thank you.

I will start with an easy question, a softball over the plate. Does the Administration plan to ask Congress to extend TARP beyond October of 2010?

Secretary GEITHNER. No.

Mr. MCWATTERS. So TARP will be dead on October 3rd, 2010.

Secretary GEITHNER. This hearing should be a eulogy for TARP.

Mr. MCWATTERS. Yes. Fair enough. Fair enough.

Secretary GEITHNER. As I said many times, we are working very hard to put this program to rest, put it out of its misery. It is not going to solve all the problems facing the country. It was not designed to. We are not going to use it that way. We use it very carefully, but it has done the essential thing it was designed to do and therefore our expectation is it will be allowed to expire——

Mr. MCWATTERS. Off to the sunset. Right? Okay.

Secretary GEITHNER. Mr. McWatters, can I just say—you said one thing in your opening statement I just want to correct. You referred to a June 11th press release where you said we implied that the overall program would be profitable.

Mr. MCWATTERS. Yes.

Secretary GEITHNER. I would never have done that. In fact, in that press release, we were very explicit that the latest cost estimates were in the $100 billion range. I think those are a little high, frankly. But we have been very careful.

Now, for the bank piece of the program—you know, for many Americans, the program was defined by the really incredible act of the Government of the United States putting capital in banks that represented three-quarters of our Nation's banking system. That was a focus of most of the deep public outrage and anger—that this country got itself in the position where, to protect the economy, we had to put money in the institutions that played such an important role in causing the crisis. It is very important for Americans to understand these were investments. They came with dividends, and on every estimate I have seen of the bank piece of these programs, they will return a positive investment for the American taxpayer.

But every time we say that, I always make clear to say—and our numbers always show—that we still face a very substantial risk of losses on the range of other programs that Congress gave us the authority to enact, including the ones we inherited from the previous administration, as well as the new commitments we have made.

But I just want to make sure—I would never make that mistake and will never make that mistake. We always make sure that we tell people that we are still exposed to a very substantial risk of loss on the programs we inherited——

Mr. MCWATTERS. Right.

Secretary GEITHNER [continuing]. And on some of the things we have done like in housing.

Mr. MCWATTERS. But the metrics were sort of curious, the $194 billion versus $190 billion. I mean, to a lot of people, it looked like you were trying to say there was a $4 billion profit there when, at the end of the day, there is really a $105 billion loss according to your own numbers.

Secretary GEITHNER. One of the necessary, very important things about the way we in the United States Treasury have done these programs is we put out regular estimates, including by independent analysts, of the potential cost of these programs. It is very hard to find any country around the world that, in the wake of this crisis, has explicitly identified and provided regular, independent estimates of ultimate cost to the taxpayer. And I am very committed to that and we will keep doing that. People will come to their own judgments about ultimately what it will cost. All we can say is——

Mr. MCWATTERS. Sure, and the CBO does that and OMB does that also.

Secretary GEITHNER. And they will change. You know, life is uncertain. But these programs will cost a fraction of what the critics feared and what the architects of the program thought was likely, a very small fraction. And the best way to measure this is to look at these projected costs relative to, for example, the S&L crisis in the 1990s, a much more modest crisis, much more simple to solve, still devastating for the communities affected, but dramatically higher costs from a much smaller crisis. But anyway, these are things that people are going to be able to look at independently over history.

Mr. MCWATTERS. But at the end of the day, $105 billion is a lot of money.

Secretary GEITHNER. Absolutely, and that is why we are working so hard to make sure we sure we bring those costs down and we are doing everything we can to minimize our risk of exposure to future losses.

Mr. MCWATTERS. Well, let me ask you this. Is Treasury contemplating the allocation of any TARP funds to any new programs before October 3rd?

Secretary GEITHNER. No. As I said in response to Chair Warren's question, at this stage we are not contemplating any new programs using this authority. Again, we have got an obligation of care and prudence in this. We are very reluctant to do things unless we think there is a very, very high return on the taxpayers' investment, and we think this is the set of programs today that strikes that balance.

Mr. MCWATTERS. How about additional TARP funds to any existing TARP programs?

Secretary GEITHNER. No. We have no plans of adding to the current estimates we have put out of these programs.

Mr. MCWATTERS. Okay.

Secretary GEITHNER. First of all, for perspective, most Americans think we went in and spent $700 billion, and we are never going to see it again. In fact, we actually have put out about half of that. We have got more than half of that back already, and we have substantially reduced the estimates we started with about how much we would ultimately commit to these programs.

Mr. MCWATTERS. Okay. My time is up.

Chair WARREN. Mr. Silvers.

Mr. SILVERS. Mr. Secretary, I hope I conveyed in my opening remarks my sense that the analysis you just went through is absolutely correct, and I think you and your team are to be commended for getting where we have gotten.

With that intro, I want to shift to the question of the interaction of TARP with the larger economy. I asked our staff to give me an updated list of the metrics of lending. It comports with your written testimony that we are continuing to see declines in loan levels pretty much across all the different ways in which they are measured. As our chair noted, we think there are some deficiencies in how much data we are collecting. We would love to see you all collect more.

My question to you is this. Given that data at a time when I think the Administration's view is that we are in a recovery mode, the economy is growing, it appears as though the private credit system is acting as a lag on the growth of the economy. That would appear to be not what we were trying to get out of TARP. Can you give an analysis of that and what steps you think need to be taken to address it?

Secretary GEITHNER. This is a very complicated question, and you are right. It is the heart of any evaluation of the effectiveness of any financial strategy like this.

But I have a somewhat different view, which is that I think that if you look at most measures we can point to of the cost of credit, of overall financial conditions, they do not suggest that the financial system today is a source of weakness for the overall economy. In fact, I would say the opposite. There is not a chance that this economy would have started to grow again in the second quarter of last year. There is not a chance we would have had this level of economic growth and this early a return to an economy still starting to create jobs again, adding hours, incomes growing again, without the dramatic actions we took, however unpopular, to bring down the cost of credit and stabilize the system. Now, this is not something that you can know for certain.

It is absolutely the case that in the housing market, in the commercial real estate market, in the context of small businesses that were unlucky in their bank or in parts of the country that are still at the epicenter of the housing crisis or have high unemployment rates, that credit is still very hard to get. But I do not think on the available evidence today you can say that the financial sector itself is operating as a significant drag on the recovery.

One of the reasons why we decided—I am going to finish quite quickly. Just give me one second.

Mr. SILVERS. Yes.

Secretary GEITHNER. One of the reasons we decided to act so forcefully to recapitalize the banking system early on in the crisis was we wanted to make sure the system was going to be able to finance recovery, finance growth, and would not operate as a drag on growth. And I think we are in a very good position to achieve that outcome, again acknowledging that there is still a lot of damage out there that is going to take some time——

Mr. SILVERS. But, Mr. Secretary, I think maybe you are not confronting what I was asking quite head on. I do not disagree with you that it could have been much worse, that the situation as it was in 2008 and early 2009 is significantly worse than today. My concern is that the situation today is not what it should be at this moment in an economic recovery in terms of the behavior of the private credit system, not so much in housing. But it is not clear we really have a private credit system in housing at the moment with the level of Government support that remains there on the Fed's side, but more on the business side, which is where the job growth needs to come from. And that brings us back to what I said in my opening statement about a chronic problem replacing an acute one.

I wondered if you could focus more specifically on that question.

Secretary GEITHNER. Again, let me try a slightly different approach.

The best measure we have about whether the financial system is a constraint on growth is what is the price of a loan, credit. So look at the cost of municipal borrowing, mortgages, business credit in almost any sector. They are not just lower than they were at the peak of the crisis. They are very low.

Another example on this question is if you look at the balance sheets, how much cash businesses have on hand across the American economy—again, the averages mask lots of variation, but the business sector as a whole has very, very strong balance sheets and is sitting on a lot of cash.

Now, I completely agree with you about the basic risk, which is we do not want to have a recovery that is constrained by credit that is too tight. And credit is still too tight in significant parts of the American economy.

But on those two measures, I would say I do not believe that we face a risk of a chronic problem. I would not use that word. But we are going to keep making sure that we are doing things to make sure this economy is growing again as strong as it can and that we are improving the process of repair that has started across the system.

Mr. SILVERS. I think most economists would say that the fact that businesses are sitting on a lot of cash is not necessarily a good thing in relation to our recovery. What is your understanding——

Secretary GEITHNER. That I would agree with. But again, I was saying as a measure of financial headwinds, it is a good measure.

Mr. Silvers, I would say that, again, this economy—we still have, I think, roughly eight million Americans still out of work. People are still living with a basic level of financial insecurity that they have not experienced in decades. So you are absolutely right about that, and we are still at the early stage of fixing what was broken in this economy. That is going to take more time.

Mr. SILVERS. The Chair was kind enough to give each of us the same time she took. So I am going to use it.

What I am pushing on is that if you look at those reserves of cash, although you may have data I do not have, I believe that they are weighted toward those companies that have access to public credit markets where the recovery has been more dramatic. If that is not so, I would appreciate hearing about that. Our anecdotal experience doing hearings and the like, and our reports, suggests that if you have to deal with the banks as your source of credit, you have got a much tougher situation as a business person and the fact that the price of credit—let us put it this way. I think the testimony we have heard from small business people is that the bank may post a rate at the window, but it is not available to them. The money is not available at that rate. And that feels like a serious problem, does it not?

Secretary GEITHNER. Well, I agree with you it is a serious problem. I totally agree. That is why we have asked Congress to enact a set of legislation that would help mitigate that problem. So I am not sure that we disagree.

I would just say that on your basic question about whether on the available evidence you have a financial system today that is a source of restraint on growth, I do not believe that would be a fair characterization of the overall average of the American economy. Absolutely, in parts of the country, in particular sectors, that is the case. And it would be surprising if it were not the case, given the extent of this.

Chair WARREN. Thank you, Mr. Secretary.

Dr. Troske.

Dr. TROSKE. Thank you.

So I guess I would like to start off by getting your thoughts on or have you respond to concerns expressed by many that for large financial institutions and their creditors, the Federal Government has essentially privatized profits but socialized the losses. I think that seems to be one of the main frustrations that a lot of people feel about the TARP program. So maybe you could give me your thoughts on that.

Secretary GEITHNER. I thought your opening statement was very interesting. I listened very carefully and it is worth going back to let me just answer a little bit of what I think about why we got into this mess.

Dr. TROSKE. Okay.

Secretary GEITHNER. You are absolutely right. Market discipline failed. The market failed to constrain risk-taking by financial institutions. That had two causes.

One was a classic moral hazard risk, the expectation that the Government would come in and insulate private creditors from losses. That was acute and conspicuous in the case of the GSEs.

But the crisis had another cause and it was much more powerful in the moment, and that was that the market, financial markets had financed a huge growth in leverage in a set of institutions that were allowed to operate outside the constraints of regulation on capital and leverage. For example, in AIG and many of our investment banks and a vast range of nonbank financial companies, some of whom called themselves thrifts, those institutions were able to operate outside the set of constraints and in overwhelming cases without any history or expectation of government support.

Now, that is not something you can attribute to moral hazard. That was just a classic lack of judgment by people financing these firms that we might face a recession with acute losses in housing prices.

But the key thing is, do we have a set of reforms now in prospect that will address that risk? And what these reform bills do—and this is fundamentally important—is to make sure that those institutions that essentially operate like banks, whatever you call them, and take risks as banks are important to the functioning of the economy. We will constrain their risk-taking. Whether you call them AIG or you call them Goldman Sachs or you call them J.P. Morgan Chase, we will constrain the leverage and risk they can take on. And this is very important. And if they mess up in the future, if they end up getting themselves in a position where they cannot survive on their own, then we will step in and dismember them safely, minimize risk of loss to the taxpayer, make sure that they can be broken up by a quasi-bankruptcy type mechanism. That is what this reform bill does.

The absence of that authority to constrain risk-taking in the crisis prevention context and the absence of tools to manage their unwinding is what forced us to take those exceptionally offensive measures in the fall of 2008 and the first half of 2009 to put out the financial fire.

Dr. TROSKE. Well, I guess the example of Long-Term Capital Management would be one of a financial firm and not a bank where the Government did come in and backstop the firm. Now, they did not provide taxpayer money, but they did arrange a rescue of that firm which perhaps would lead one to think that that is what the Government was going to do for these other firms as well, that rescue became an expected norm in this.

There are entities out there, presumably credit holders and equity holders, who are supposed to be regulating these firms. The creditors who do not experience the upside gain are the ones that have the most to lose and should have been the ones doing it. It is not a large stretch to think that they were failing in that role because they felt that they were going to be guaranteed a return regardless of what happens.

Secretary GEITHNER. I think you are right that all financial systems have this expectation, this risk of moral hazard, this expectation that in the extreme event it is possible the government would act. And that is the job of oversight and policy and government, to make sure that because of that risk, you have tough, well designed constraints on leverage that are imposed and enforced across the system ahead of the crisis. So none of us run a system and no country runs a system on the expectation that market discipline alone is adequate to constrain risk-taking. All countries constrain leverage through capital requirements. Some do better than others. We did it quite well in some parts of the system, but did it very poorly or inadequately or not at all in large parts of our system, and that is something we are going to change.

Dr. TROSKE. And you have mentioned this, the systemic risk regulator or whatever you want to call it. I mean, under the current system there was the President's Working Group on Financial Markets which was supposed to be assessing overall systemic risks to the economy. At least, that is my understanding. You would certainly know more about it than me.

So what is the difference between what we are setting up going forward and what we have now—because it is the same players as far as I can tell—many of the same players. What powers will they have that are different than what they have currently?

Secretary GEITHNER. Excellent question, and both you and Mr. McWatters have made the basic point. I will tell you what I believe.

We are not going to design a system that depends on the foresight and wisdom of officials sitting in Washington in those agencies to come in and preempt—act preemptively to diffuse all future sources of risk and crises. We hope that will happen in the future. Maybe it will happen, but that is not the premise on which we are reforming the system.

What we are doing is to make sure there are clear, public, enforceable constraints on the types of risks that can imperil a system through constraints on leverage and capital and liquidity. We think that is the most realistic way to make sure that the system runs with much greater cushions against future sources of loss, shocks, uncertainty, stress. We will not know where those are going to come from.

And I agree very much with the premise of both your questions that if we design the system to work only if regulators are perfectly wise and brave and preemptive, then we will be consigned to a fate of future crises like this, and that is not the reforms we are supporting. And I agree with your skepticism about that approach.

Dr. TROSKE. One more. I guess ultimately if the Government is faced with another crisis in which several institutions are failing simultaneously, is there anything that will prevent them from enacting a TARP II in the situation in which there is a Bear Stearns and an AIG and a Lehman, and everybody is failing at approximately the same time? Nothing that I have seen would change anything from what happened in the past.

Secretary GEITHNER. Excellent question. That was the system we had, and that is what put the Government of the United States in the outrageous position of having no choices but to come in and commit an extraordinary amount of resources to put out that financial fire. That was the necessary, unavoidable situation, given the system we had.

But the reforms that are on the verge of enactment here really do help fix that problem because again, apart from the crisis prevention authority that they give the Government, which the Government did not have—it did not have the ability to constrain risk-taking across vast swaths of the American financial system because they did not call themselves banks, and we let them operate like banks. It fixes that problem, but it also—and this is very important—makes sure that if, in the end, an individual firm gets itself in the mess like so many did in this crisis, we will be able to let them fail, ensure they fail, dismember them safely, wind them down, not to give them the chance to survive again, operate again, but to put them out of their misery without the taxpayer being forced to absorb these losses or the businesses and families across the country left with all the collateral damage of their basic mistakes.

These are not great metaphors. But what you want in a crisis is you want to have the ability to step in. There is fire in a firm or a set of firms because they were imprudent. You want to be able to ensure you can draw a line around that fire, prevent the fire from jumping the fire break and infecting and imperiling the stability of the rest of the system. And that is what this reform does.

Chair WARREN. Mr. Secretary.

Secretary GEITHNER. Thank you.

Chair WARREN. Thank you.

Superintendent Neiman.

Mr. NEIMAN. Thank you.

Mr. Secretary, I would like to start off with the HAMP program and foreclosure prevention. In the Treasury report issued just yesterday, trial modification cancelations nearly tripled from March to May. The number of families that have received permanent modifications under HAMP at 350,000 is now surpassed by the number that have been pushed out of the program, almost 430,000. It is deeply troubling that the homeowners who relied on and trusted this Government program may be left out in the cold. From the report, of those who were dropped out—the 150,000 in May alone—over 70 percent of those individuals have been making timely payments for 6 months or more.

First, we need to really understand why these hundreds of thousands of modifications were canceled. And while the report issued yesterday cites several reasons, can you share with us the primary reason that people were dropped out and what assurances can we give them that they were appropriately considered?

Secretary GEITHNER. The overwhelming reason is they were unable to prove income and therefore unable to demonstrate that they were eligible for the program. We made a conscious choice last summer in putting this program in place, which is that we would do everything we could to maximize the number of families who were potentially eligible for this program to get immediate cash flow assistance. Because of that strategy, we had roughly, at the peak, 1.2 million Americans benefit from temporary loan modifications that, as you know, substantially reduced their monthly payments. But we let them do that on stated income, knowing that we would have to go back and be able to demonstrate that they were truly eligible for that.

Now, that inevitably put us in the position where we are today, which is that by erring on the side of speed, we put ourselves in the position where we were inevitably vulnerable to the possibility that many of those homeowners who thought they were eligible, said they were eligible, were unable to prove income. Therefore, we are in a position today where we are, as you said, canceling some of those modifications.

Now, more than two-thirds, I think, of those people who, as you said, are in that category of canceled modifications are benefitting from other modification programs that their banks offer that we are not supporting. So that helps temper a little bit the consequences of not being eligible for this program. But again, we have a careful balance to strike, which is to make sure that we are devoting these scarce resources to people that are able to prove they are eligible for the benefit.

Mr. NEIMAN. So what kind of verifiability, audit compliance can we provide to document this? We hear anecdotal information about documents being lost, and servicer error in verifying income and processing other documentation. How can we assure and provide that level of comfort that servicers are acting properly?

Secretary GEITHNER. I think it is very important to say that servicers have done a terrible job of making sure that they are doing everything they can to meet the needs of their customers who are facing the possibility of losing their home and the most important part of their financial security. They still have some distance to go to try to make up for that series of basic—how should I say it—mistakes, inadequacies in performance.

So what we have tried to do is simplify and reduce the documentation burdens. And we have put enormous pressure on servicers by putting out very detailed public metrics of performance so that people can judge for themselves who is doing a good job on the service side of meeting the needs of their customers and who is lagging behind in that case, and we will continue to put as much pressure as we can on them to improve the quality of service they are giving their customers.

Mr. NEIMAN. Now, you made reference to the fact that a majority of those who have dropped out of the program—whose trial modifications were canceled—were offered non-HAMP modifications, these proprietary modifications by the servicer. But is it not true that the true test will be whether the borrower is better off? Until we see the statistics on those non-HAMP modifications to—see if there has been an increase in the cost or the monthly payment—will we know whether those are truly sustainable?

Secretary GEITHNER. I completely agree with you, and that is a very hard thing to measure, but I completely agree with you.

I think I would say the following. Unlike the situation two years ago before the Government put out this basic standard for modifications, most of the private modifications out there did not meet that test. They left the borrower with as much debt, if not more debt than they had coming in.

But since then—again, the general impression I have is that the Government standard has improved and raised the standard of those private mod programs, and that helps, a little bit, mitigate that risk. But you are right about the basic——

Mr. NEIMAN. Do you expect that the public will be seeing any data? Has the Treasury been requesting, even if on a voluntary basis, some of the key elements of those non-HAMP modifications?

Secretary GEITHNER. We are continuing to look for ways to do that and would be happy to try to be responsive about explaining what we think is achievable in that area.

Mr. NEIMAN. You know, another surprise that we keep hearing from borrowers who are now being presented who have been dropped from the program is that they are responsible now in some cases for lump sum payments for the discounted amount of principal and interest that was foregone during that trial modification. And even some borrowers are being assessed late payments for the six, seven, or eight months they were in the program.

Secretary GEITHNER. Well, as I said, I do not believe that any of the banks that are at the center of this problem are doing an adequate job now of making up for the mistakes they made and helping their customers get through this problem. And we are going to continue to, as I said, put enormous pressure on them to try to make sure they are doing a better job day by day in meeting those basic obligations to their customers.

Mr. NEIMAN. One provision that I think would be extremely helpful—I have been calling for this for a while—is the creation of a homeowners advocate within the Treasury. Senator Franken has proposed an amendment that has passed the Senate, and I would hope with the Administration's support, we would see a provision like that and seek your support that it would be adopted.

Secretary GEITHNER. I am happy to consider that.

We are fortunate to have some very talented people who know a lot about housing involved in essentially designing these programs. We do so alongside the excellent people at HUD led by Shaun Donovan, and we have a series of hotlines, appeal process to try to—again, we are moving in that direction. But I would be happy to consider that.

Mr. NEIMAN. Having an appeal process that people know they can reach out to Treasury would be a critically important part in my opinion.

Thank you very much.

Chair WARREN. Thank you.

So, Mr. Secretary, I want to go back to this question about stable, functional financial systems. We talked about the small banks, the 3,000 out of 8,000 that have these potentially dangerous concentrations in commercial real estate.

I want to look at the top end. Six of the 19 stress-tested banks hold commercial real estate loans that exceed 100 percent of their tier one capital. As you know, the stress tests that were performed in February of 2009 calculated possible losses only through December of 2010, but the commercial real estate losses, because of the way they are set up, are likely to be much larger in 2011, 2012, and on into 2013.

How can you be confident about the stability of these financial institutions without re-running the stress tests to account for the coming troubles in commercial real estate lending?

Secretary GEITHNER. As I said, these loans and losses and assets are going to be an ongoing source of challenge to these institutions, absolutely. But I think overall it is fair to say, although this is really a question for the supervisors, that actual losses on the books of the institutions that were subject to the stress test are coming in significantly under those estimates on average overall. And that is really the ultimate test of this stuff.

We are able to say today—but again, this is a question we look at all the time on an ongoing basis—that based on what we have seen so far, the losses are doing better than projected and therefore the capital positions of these institutions are even better than we thought we were achieving at the time of the stress test.

Chair WARREN. But at the time of the stress tests, we only accounted for losses through 2010, and we know that the losses on commercial real estate, because they were on five-year resets unlike the subprime residential mortgages, are coming up for major resets in 2011, 2012, and 2013. That is outside the range of the original stress test.

So I am glad that you think the numbers look better that you had anticipated for 2010——

Secretary GEITHNER. I would say even projected losses——

Chair WARREN. Does this mean you are running a mini-stress test?

Secretary GEITHNER. Well, again, what our supervisors have done—and they did this, again, on a plan that we designed—is they have put in place a much higher level of disclosure on the exposures the U.S. banking system retains, subjected them to much more rigorous estimates of potential losses in an extreme scenario than was true for any of the countries that went into this crisis. And you are seeing now countries move to adopt that basic framework. And the virtue of this approach was we pushed a lot more capital into the financial system at an early stage. And again, the best way to measure this is to look at how the market is judging the adequacy of capital levels here relative to potential risks. I think that, again, relative to expectations, is better than we would have expected. There is still a lot of challenge ahead though.

Chair WARREN. I have a feeling I am going to hear the same answer, but let me just try it again with second liens. Big banks are still carrying second liens on their books at inflated values. Many analysts believe there should be a large portion of these loans should be written off.

As of March 31st, 2010, the four largest banks held $444 billion in second mortgages and had total tier one capital of only $505 billion.

Do you have any concerns about what this means? Now we are doing commercial real estate. Now we are moving on to second mortgages?

Secretary GEITHNER. Well, of course, banks have on their balance sheet still—even though they have produced assets to some extent, they still have a lot of exposure to the challenges ahead facing the American economy. The question is how much capital are they holding against those potential losses?

Again, in the judgment of our supervisors—and I think you can see this judgment validated by the financial markets today, although as many of you pointed out, they are an imperfect measure of risk and loss. The general sense is that projected losses are less than they were expected, and therefore more capital is now held against those losses than we thought would be the case back a year ago, and that is a good thing.

Now, of course——

Chair WARREN. Let me try one more. Fannie and Freddie are pushing mortgages back to these large financial institutions because they say that the mortgages that were sold to Fannie and Freddie were not of the quality that they was represented, that there are some serious problems with them. Fannie does not disclose the requested buy-backs, but Freddie alone requested another $5 billion in buy-backs at the end of March.

So the first question is, does Treasury have a good estimate of what the total exposure is to our large financial institutions from the requests from Fannie and Freddie to buy back bad mortgages?

Secretary GEITHNER. I do not know the potential scale of that again, but I think it is very unlikely to change this basic judgment that our supervisors have that the major banks of the country now hold a level of capital against potential risks that puts them in a much stronger position than we expected even a year ago when we included this process. And that goes to each of the things you pointed out, each of the sources of potential loss still ahead.

Now, again, this is an uncertain world still. We want to be very conservative in making these assessments, as we were a year ago. And our supervisors will—and this is a great strength of our system—they continue on a regular basis—one of you say in your opening remarks that we do not contemplate stress on an ongoing basis, but that is absolutely not the case. A centerpiece of the basic reform design that we contemplate—and again, I hope this will be a global standard—is to say regularly—regular, quarterly—difficult, challenging, forward-looking assessments of potential losses at least for the major banks that dominate our financial systems.

Chair WARREN. So are you saying that those are ongoing now or they will be ongoing if regulatory reform passes?

Secretary GEITHNER. Both.

Chair WARREN. Thank you, Mr. Secretary.

Mr. McWatters.

Mr. MCWATTERS. Thank you.

Mr. Secretary, earlier you said there would be no new TARP programs, but with respect to existing TARP——

Secretary GEITHNER. I said right now, we do not contemplate putting in place new programs or adding resources beyond the amounts we initially identified.

Mr. MCWATTERS. Okay. So that means there will be no more money going to AIG or GMAC.

Secretary GEITHNER. Again, I will answer your question again. We do not anticipate at this stage putting more money into those existing programs or into those institutions beyond the levels that are out there that are subject to public knowledge now.

Mr. MCWATTERS. And the same would apply for Chrysler and GM.

Secretary GEITHNER. Yes. Again, let me tell you—let us do the other side of your question. We are now on a path to exit from those companies much more quickly at a much lower estimate of losses than any of us anticipated. We are starting that process. AIG—we are bringing down the risks very dramatically, we already have sold successfully significant parts of that company. We are going to continue to move as aggressively as we can to get the Government out of those investments, which we only took, of course, under extreme duress extremely reluctantly. We are making the same basic strategy in GM and Chrysler. Again, those are commitments we inherited. We are trying to reduce them as quickly as we can at as low a risk of loss to the taxpayers as we can.

Mr. McWATTERS. If there was a double-dip recession and Goldman and Citi and Bank of America and the usual group of "too big to fail" institutions came to your office and said we are experiencing a liquidity crisis, would you advance them money under TARP until October 3rd?

Secretary GEITHNER. I do not ever answer those kind of questions just because they are sort of unanswerable, but if financial reform is in place, then we will have the benefit of a very well designed quasi-bankruptcy process and a set of emergency measures to contain the risk of a panic that we did not have in place in the fall of 2008. And that would give us better choices at that stage.

Mr. McWATTERS. So assuming those are not in place and we have the last quarter of 2008 again——

Secretary GEITHNER. You are talking about in the 12 weeks remaining——

Mr. McWATTERS. Yes.

Secretary GEITHNER [continuing]. Of this program?

Mr. McWATTERS. Yes.

Secretary GEITHNER. Well, again, our job and my responsibility is to make sure we are safeguarding the basic strength of the American financial system, but again, our system, because of the actions we took, is in a much stronger position still to manage through these challenges ahead than any of us expected, and I think that is a remarkable thing and a very important thing. And we are going to do everything we can to safeguard that.

Mr. McWATTERS. Okay. Let us say financial reform is in place. The same people come to you and say, you know, there is a systemic regulator. The systemic regulator was supposed to look into a crystal ball and see stuff and——

Secretary GEITHNER. Mr. McWatters, that is not what this reform does. And as I said—I will say it again—we are not designing a financial reform program that rests on the ability of supervisors to look into some early warning system and have perfect foresight and judgment and be able to come in and preemptively—we are not designing a system that requires that. We will do our best at that, but we have fundamentally different strategies to say that we are going to force the system to run with less leverage, less risk of funding, less exposure to catastrophic risk than was true before. And that is the best protection we have against systemic financial crises.

Mr. McWATTERS. Yes, but the problem with that is that AIG was not a mystery to people. Most people on Wall Street understood that AIG was writing trillions of dollars of credit default swaps. Most people understood that AIG was purchasing billions of dollars of residential mortgage-backed securities. The problem was, even though people recognized it, they did not recognize it as a risk. They did not look at that as risky behavior.

Secretary GEITHNER. I do not agree with that. I think this crisis is littered with examples of people failing to foresee risks that end up causing catastrophic damage.

The AIG failure is just a different—and it is a more simple failure. There was nobody responsible with the authority and the capacity to constrain risk-taking by that institution. There were, as you said, tens and tens of regulators across the United States and across the country, but none of them were responsible for constraining the risks that AIG as a group took on, and that was an avoidable mistake, easy to avoid frankly.

Mr. MCWATTERS. Yes. AIG had 400 regulators throughout the world.

Secretary GEITHNER. A remarkable thing.

Mr. MCWATTERS. But, I mean, you are saying if there is one more—there is a systemic regulator——

Secretary GEITHNER. You said something else in your remarks that is not quite not right. We are not adding new regulators. We are actually reducing the number of regulators in our system. All we are doing, frankly, is making sure that the people whose job it is to manage financial stability for the country have the authority to constrain risk-taking where those risks could cause catastrophic damage. That did not exist before this crisis. It is why we had the crisis, and that is not something we are prepared to live with in the future.

And AIG is the perfect example but it is not the only example because you can look at Lehman or Bear Stearns or Merrill Lynch or a whole raft of non-bank financial companies who were taking substantial risks. The tragic feature of our system was nobody had the tools and responsibility for constraining those risks ahead of time. And when they messed up, we did not have the tools or the choices to be able to let those failures happen without catastrophic damage.

Mr. MCWATTERS. But that assumes you know what the risks are——

Secretary GEITHNER. No, no.

Mr. MCWATTERS [continuing]. That you can look into the future.

Secretary GEITHNER. Again, the great virtue of capital-constraining leverage is to recognize the fact that we live in an inherently uncertain world. No one will know with confidence what the risk is or probability is of potential losses associated with some future recession. You do not know that.

The only thing you can do—and this is a fundamentally conservative instinct—is to force these institutions to run with less risk against the unlikely but possible risk of another great recession. And that is an effective tool of constraining risks. Firms that run with less leverage in a crisis do much better than those that run with more leverage. That is an achievable object of reform.

Mr. MCWATTERS. If you define a risk appropriately, and you enforce the rules appropriately, that is the only way.

Secretary GEITHNER. Well, again, we think the basic lesson of this crisis is simple, an objectively measurable set of basic constraints on leverage. Banks should fund more conservatively. They should not be exposed to the possibility that overnight people would withdraw tens of billions of exposure and leave them with the choice of liquidating or doing massive liquidation and deleveraging that can put huge pressure on the rest of the system.

So I mean, you should judge these things by the alternative. I am not aware of any credible argument that there is a more effective basic tool than constraints on leverage through capital requirements and liquidity funding as a safeguard. Now, they will not prevent all firms from failing, and we are going to run a system where firms can still fail. That is an important part. It helps improve market discipline. But I do not know of any credible alternative and no other fundamental feature of financial oversight that does not begin with well designed, measurable, simple constraints on leverage. They will not prevent all crises. They will not prevent countries from taking too much risk, but they will protect the system from the kind of damage we saw in this crisis.

Mr. MCWATTERS. Okay, thank you. My time is up.

I will just close by saying I am not sure, with 400 regulators with volumes of regulations, that adding a few more regulations or another regulator is necessarily going to solve a problem which will come in the future from creative investment bankers and an investment community that will derive new types of instruments that, for example, 10 or 15 years ago we did not see. So I will leave it at that.

Secretary GEITHNER. But, Chair Warren, let me just say maybe we agree more than you think.

But again, the feature of our system was not that AIG was crawling with supervisors with the authority to constrain their risk-taking. That was absent not present in our system. Now, you are right. If it was present, then you are right. Then changing the deck chairs in the supervisory community would not be an effective response and we are not going to do that. That is not our proposal. It is a much more simple prescription which is to say institutions that take risk to play this important role of fundamentally banking in our system need to be subject to conservative constraints on leverage and risk-taking. AIG was not. We will make sure it is.

Chair WARREN. Thank you, Mr. Secretary.

Mr. Silvers.

Mr. SILVERS. Well, I cannot resist continuing this line of discussion.

Let me observe first, Mr. Secretary, that I think that your fundamental observations about this set of questions are absolutely correct. Our report on AIG showed two fundamental things. One was that the lines of business that led to the collapse of AIG were those that were unregulated despite the presence of the 400 regulators. The 400 regulator number is, in fact, just an indication of the fact that AIG was a global insurance company and there are insurance regulators in every country they operate in.

The second thing that I think our report showed was that although I think that we as a panel may disagree with you, Mr. Secretary, about some aspects of what you did with the choices you had, it is very clear that the choice you did not have in your former role at the Federal Reserve Bank in New York—your predecessor at the Treasury, the Fed Board of Governors—the choice you did not have was to access a resolution authority that would have enabled you to pick and choose what to do with different creditors in a systemic crisis.

So I just want to observe that I think your analysis of those two matters is spot on.

Now, I want to take it a little further from there, though. We learned as a panel—and it is reflected in our report on AIG—how powerful certain aspects of AIG's structure as a holding company, what a powerful force they exert on the choices available during the crisis, in particular, the way in which the unregulated, unguaranteed subsidiaries were tied to the regulated guaranteed subsidiaries of AIG. That is, the derivatives arm and the insurance companies were tied together by credit rating considerations and by interlocking default terms in the various credit agreements in that big, complicated firm.

That seems to me to be a powerful argument for making sure that in the future financial firms that have government guarantees behind them, insured deposits, insurance companies are not so tied up with very risky lines of business, derivatives, proprietary trading, hedge funds and the like, and thus is a powerful argument for two items currently being debated in the financial reform bill.

The first is the Volcker Rule, the notion that we ought to basically say bank holding companies cannot do proprietary trading, cannot invest in hedge funds, cannot invest in private equity firms because it gives rise to this kind of problem.

The second is section 716, the section that essentially requires that derivative dealers not be within bank holding companies or, as some have proposed, that they at least be a separate entity within bank holding companies.

In the spirit of that analysis, I would like you to explain what the Treasury Department's view is on those two issues today.

Secretary GEITHNER. Excellent question. And as you know, the members of the Commerce Committee and the chairmen involved, including Chair Lincoln and Chairman Dodd, are carefully going through those provisions to try to figure out how to make sure we come to an appropriate balance. I am very confident, on the basis of our conversation with them, that they are going to come to the right place in this stuff. I think I would just highlight the following key objectives that are guiding our approach to this stuff.

One, as you said, we want to make sure that institutions that own banks are not able to take risks, like through proprietary trading or in derivatives, if they use derivatives for proprietary trading, that could either imperil the stability of the bank or allow the firm to benefit from the access to the safety net that banks enjoy as a privilege and extend that benefit to those activities that we do not believe are central to the functions of banking.

On the other hand, it is very important to point out that the basic business of banking requires banks having the ability to hedge risks, and a central part of banking is helping their customers hedge their risks, whatever those are. And we want to make sure that the bill ultimately preserves that ability for banks to hedge the risks they take on as banks and are able to help meet the needs of their customers in hedging their risks.

As I said, I am very confident we are going to come to a good balance on these provisions, and this bill will do an exceptionally important thing of bringing comprehensive oversight and restraint to derivatives markets that still have enormous benefits to the economy as a whole but, as we saw in this crisis, present enormous risks and would still present enormous risks if we were unable to enact these reforms.

Mr. SILVERS. Mr. Secretary, there are press reports that efforts are being made with respect to both measures I indicated to essentially weaken them through "de minimis" exceptions. And you spoke for a moment about that issue in the area of section 716 in derivatives.

Can you speak to the question of whether banks will be allowed, in the guise of a de minimis rule, to put meaningful amounts of capital into sponsored hedge funds and private equity funds.

Secretary GEITHNER. For reasons you will understand, just out of deference to the legislative process, I am not going to comment on the details of those provisions.

Mr. SILVERS. Oh, no. I am talking about Treasury's view, not on what the members of the committee will do.

Secretary GEITHNER. Still, I think we need to let this process work, and the members of the committee are doing a very difficult—they are facing a very difficult job still trying to find a set of measures that will command broad support. But again, I am very confident this bill will do the necessary thing of making sure that we are constraining risk-taking by these institutions, bringing derivatives markets under comprehensive oversight, and establishing the type of quasi-bankruptcy process for institutions that are so important.

Mr. SILVERS. I would just observe—and my time has expired, but I would just observe that when you are talking about leveraged investments under a bank logo, that a de minimis exception could very easily blow up a capital structure and that it would seem to me that the lesson of our AIG report is do not allow that.

Secretary GEITHNER. We are not going to support an outcome that would create that risk, and we are also—could I just elaborate on this for one second? We also do not want to support an outcome that will recreate the basic balance of risk-taking we saw in this system where people put a bunch of risks in separate affiliates with no capacity to constrain those risks, and that was not a good outcome for the system.

Chair WARREN. Dr. Troske.

Dr. TROSKE. I would like to talk a little bit about the CPP program and the use of that program for the small, or the non-stress-tested banks. I guess I would like to hear sort of your rationale for why liquidity was invested in this part of the banking system, why this program was—what the goals were from this program.

Secretary GEITHNER. Sorry. For the?

Dr. TROSKE. The use of these funds for the small, the non-stress-tested banks.

Secretary GEITHNER. Excellent question. Two simple reasons. The first of these just guided everything we did in the crisis.

Again, the central rationale for the Government's emergency actions were to make sure that credit, which did not exist at that time, was going to be open again to American businesses and families because without that, there would be no recovery, no growth, no job creation.

So for that reason, small banks, as you know, get about half of their credit from—small businesses get about half their credit from small banks. For that reason, we thought it made sense and it would seem fair to make sure that they had the same access to the capital programs that were initially put in place to stabilize the system. So for the reason of fairness and for the pragmatic reason that they play an important role in the provision of credit to businesses, we thought it was important to make sure they had the same access to these programs as did the major Wall Street institutions.

Dr. TROSKE. So staying with the smaller parts of the banking sector, our understanding—well, I did not work on the report but I did read the panel's May report. It seems like many of these banks suffered some significant stigma associated with taking these funds. Large banks also seem to suffer from perhaps rules that they did not know that they were going to face going into the program, the rules regarding the payment of dividends and the payment of their executives, leading them to scramble rather quickly to get out of the program. And clearly this was an effort to inject liquidity into the system, something that is important to be able to do in a financial crisis.

Looking forward, if we ever have another financial crisis, have these programs impaired our ability to inject liquidity into the system given the reluctance of many of these banks to—the seeming reluctance of many of these banks to participate under this current program?

Secretary GEITHNER. I hope so in the sense that, again, the central challenge you face in designing reforms over the financial system is to reduce expectations that the Government will be there to protect you from your mistakes in the future. And that is why these reform bills are so important because they give us the tools to definitively alter those expectations, and that is very important because of the things that we had to do in the crisis to put out the financial fire.

Dr. TROSKE. I guess I would make a distinction between injecting liquidity into the system and providing support for failing institutions. They are very different roles, as you are well aware. So I think it is important to maintain the ability to inject liquidity into the system because I view the support that was given to small banks as more of an injection of liquidity since presumably, as you indicated already, they were healthy banks. They were not failing institutions.

Secretary GEITHNER. I, of course, completely agree with you that a necessary part of the arsenal tools you need in a financial crisis is to make sure that institutions that are solvent can fund themselves. Without that, nothing is possible and the system will come crashing down, as our system almost did. Back in September 2008, we were on the verge of a classic run on a banking system, something we had not seen since the Great Depression. So for that reason, I completely agree with you that a central part of the arsenal of response is to make sure that governments have the ability to meet the funding needs of solvent institutions.

But, again, in doing that, preserving that flexibility, you will also have to make sure that people do not make judgments about how much they lend to institutions, how much risk they take on the expectation the Government will be there again if they were mistaken or imprudent in their judgments. And that is the classic vital challenge of reform.

Dr. TROSKE. Let me change gears just a little bit and turn to the housing market, which has been mentioned a couple times before.

For almost 30 years, between 1965 and 1995, the rate of home ownership in this country was stable at 65 percent. Starting in 1995, it grew quite dramatically through actions of a variety of different people to about 69 percent.

My own view of the housing market is, one, we are not going to return to stability until we return to a rate in which 65 percent of households own their own homes. We are currently somewhere between 68 and 67 percent.

Many of the programs that have been enacted seem to sort of simply extend this process through which we get back to a rate of home ownership that is more sustainable. Would a better program not be one which was designed to move people into a more appropriate housing situation as opposed to keeping them in one that is just not sustainable over the long run?

Secretary GEITHNER. I think you are describing exactly the objectives that have shaped this program, which is why it is subject to so much criticism from people who had hoped that the program would be designed to keep a much larger fraction of Americans in their homes. Our program was designed exactly as you said, to make sure that those Americans—and there are many—who have a realistic prospect of staying in their home, who can afford to stay in their home in that context, have the option and the chance to do that. But this program was not designed to prevent foreclosures. It was not designed to sustain home ownership at a level that would be unachievable and imprudent to try and do. There is no perfect way to strike that balance, but we have tried to do something that is very close to the test you laid out.

Dr. TROSKE. Thank you.

Chair WARREN. Superintendent Neiman.

Mr. NEIMAN. Mr. Secretary, I would like to come back to your recent remarks about community and regional banks as a key source of credit for small businesses, because much of the public focus and our prior COP reports have been on the largest TARP recipients that were part of the stress tests. Our July report that we are working on at this very moment will provide a unique kind of window into the performance and health of the hundreds of banks participating in the program and to attempt to assess the effectiveness of the TARP program for those banks below the top 19.

So to help us to focus on that—and before assessing Treasury's effectiveness—we need to understand the clear goals. I think you just referenced two: one, fairness and providing small banks with the same access to capital as the larger banks and two, lending.

Do you want to expand upon that or are those the two critical issues? Was the focus on lending? Was the focus on the health of the community banks together, maybe as too many to fail as opposed to too large to fail?

Secretary GEITHNER. Basic objectives of our strategy again are to make sure we are safeguarding the financial security of Americans and that we have a financial system that is able to meet the credit needs of Main Street America. So everything we did was shaped by those two basic objectives.

Now, because as you said, you know, we are a Nation of 9,000 banks, not 12 banks, not 25 banks, 9,000 banks and most small businesses get most of their credit from small banks.

Mr. NEIMAN. And as I recall I think we had only about 700 community banks participating in that program.

Secretary GEITHNER. Exactly. Right now we have roughly $11 billion of investments remaining in banks that are below $10 billion in assets. Somewhat less than 600 banks meet that test. Again, we did that for the simple reason of fairness. We thought they should have the same access to this set of investments that we gave the major institutions, and we did it because we thought it would be important to try to make sure that their business customers and individual customers had a better chance of getting through this with access to credit on affordable terms. It is a simple, pragmatic rationale. But as you said, it is still a challenge for many of those banks and therefore for many of their business customers.

Mr. NEIMAN. What would be your assessment of the program in meeting those goals and particularly how those banks utilized that capital?

Secretary GEITHNER. The available evidence on how they use the capital is quite favorable. Just to give you one basic measure, if you compare small banks that took TARP capital against those that did not, the former category increased lending at about twice the rate of banks that did not take TARP capital. That is a pretty good, simple measure. We are happy to share with you all the details of that assessment.

And of course, for many banks, access to TARP capital meant they did not have to reduce lending to meet their capital requirements. So you have that test again.

Again, the best test is what has happened to the cost of credit, but it is still hard to get. But I think that it has been available.

Now, having said that, fundamentally this program did not meet our objectives because, as many of you have pointed out, because of concern about the conditions that might come in the future, because of concern about the stigma of the appearance that you participated in these programs out of weakness and not out of strength. We had banks by the hundreds I think pull back their applications from the Treasury and from their primary regulator for capital because they did not want to be subjected to either the stigma or to the fear of conditions, which is why we have legislation now pending before the Congress—it has been pending now for six months—to build outside of TARP and outside of those risks a very carefully designed set of programs at the State level and the federal level to help small banks get through this.

Mr. NEIMAN. And your level of confidence that that program will overcome the TARP stigma and attract demand?

Secretary GEITHNER. Very high. But, again, you have to judge it relative to the alternative. We looked at a whole range of alternatives. This seemed to offer the best prospects of breaking that set of constraints.

Mr. NEIMAN. We have a program in New York that you may well remember from your days at the Fed, the New York Business Development Corporation. It is comprised of member banks which not only provide equity but wholesale funding and it acts as a lending consortium for loans to small businesses, and it makes loans that were marginal credits that the individual funding banks may not have made. So we have raised this on a number of occasions and would offer it to you as a suggestion maybe for consideration at the national level because of not only taking second looks at loans passed up by member banks but also spreading risk and providing expertise in a particular business lending. I do not think it is clear under the SBLF that the banks could utilize this capital to leverage investments or lending to bank consortiums.

Secretary GEITHNER. Well, I actually think we have this thing we call the State option that exists in this draft legislation alongside the small business lending facility, and that option is designed to provide support for exactly those types of programs. There is a great diversity of those programs across the country with a long history people can look at to figure out what makes the most sense. Again, the virtue of the way we designed this is you have a new Federal program designed so that if you increase lending, the rate of dividends you pay the Treasury goes down. That is a pretty good incentive for using it to increase lending, but also we are providing a significant amount of assistance to States across the country that have those programs so that we are, in a sense, financing a greater diversity of programs as well.

Mr. NEIMAN. Great. Thank you.

Chair WARREN. Thank you.

I was surprised by your answer to Dr. Troske about the metric for success on the home mortgage foreclosure program. So I had not intended to ask you about this, but I want to go back. I pulled out some numbers and looked at this.

Over the 15 months that the program has been in effect, there have been 347,000 so-called permanent modifications. Fitch now has come out with an analysis that says about two-thirds of those are going to fail. So that means that over 15 months, at least by their estimate—and correct me if you think you have a better estimate—but over 15 months, the HAMP program may save 120,000, that is, permanent modifications, people who do not slip and lose again. That is against about 186,000 every month that are newly posted defaults and foreclosures.

So now I am caught in the question of what is your metric for success here.

Secretary GEITHNER. Let us step back for just one second and look at the basic strategy that the President put in place alongside the Fed.

First, we acted to bring down mortgage interest rates. That was very important to put some floor under house prices, and we acted to make it more likely and more possible that millions of Americans would be able to refinance their homes to take advantage of lower interest rates.

Chair WARREN. Mr. Secretary, I am familiar with all that you think you have done to support housing overall.

Secretary GEITHNER. Right. But the——

Chair WARREN. The question is HAMP is designed to deal with families facing foreclosure. More than a million families this year will lose their homes to foreclosure. The best estimates are that will happen next year and the year after. We are talking about literally millions of families who will lose their homes to foreclosure. HAMP is it, by and large, for them.

Secretary GEITHNER. No. Well, again, what HAMP does and what HAMP is designed to do—it was not designed to prevent all foreclosures. It could not be designed to do that.

Chair WARREN. I understand that. So my question is what is the metric for success?

Secretary GEITHNER. What HAMP is designed to try to do is to make sure that a set of people facing the risk of foreclosure have the chance of being able to afford the challenges of staying in their home.

Again, on the numbers, more than 1.5 million were offered trial modifications. 1.2 million received trial modifications. As you said, only part of those are being converted to permanent, but a substantial fraction of those that are not are being able to take advantage of other loan modification programs and therefore have a chance to stay in their homes.

Chair WARREN. Well, as Superintendent Neiman said—and we will find out what the consequences of that are, whether they are good or bad—we know that the early modification programs actually got people into more trouble, raised their overall payments, had them owing more principal than they had started out with. This is HAMP. You set aside $50 billion and what do you have to show for it?

Secretary GEITHNER. Well, again, what we have is 1.2 million Americans who got an average of a $500 reduction in their monthly payments at an early stage in this crisis that was critical and therefore a chance to keep their homes. That was enormously effective.

Chair WARREN. And passed up other opportunities they might have had to deal with their home—they might have fought their foreclosures. The point is they ultimately lost their homes.

Secretary GEITHNER. No, no.

Chair WARREN. What is the metric for success here? Is it 120,000 families saved over 15 months at a time when 186,000 are posted for new defaults and foreclosures every month? Is that a successful program? How do we decide when the program is working?

Secretary GEITHNER. You look at its results family by family, foreclosure by foreclosure, change in monthly payments by change in monthly payments, but recognizing that—and on this, I think we agree—these programs were not designed and could not have been designed responsibly to try to prevent a set of foreclosures that tragically were probably unavoidable——

Chair WARREN. Then help me with a metric. The question I want to understand, are you telling me that preventing one foreclosure would have been enough for our $50 billion?

Secretary GEITHNER. No, no. I am just——

Chair WARREN [continuing]. No. So what is an appropriate metric? Did you have an estimate when you started this of how many families you could save?

Secretary GEITHNER. Our challenge is we have tried to reach as large a fraction of eligible homeowners as we could, and we are still working toward that objective. And again, the virtue of the approach we have laid out is we have given everyone detailed numbers that they can look at not just on——

Chair WARREN. Forgive me, Mr. Secretary, but you say we designed the program from the beginning, in effect, you are saying, not to save everyone. I understand that point. But you designed it around servicers. You designed it around servicers who—I wrote it down when you said it. Servicers have done a terrible job. You designed it around voluntary participation, relying on these servicers.

We only have three months left with hundreds of thousands of families facing foreclosure. Is it time to rethink whether or not a mortgage foreclosure prevention program that is based on a group of servicers whom you describe as having done a terrible job is a program that perhaps should be redesigned?

Secretary GEITHNER. As I said, these programs will outlast the expiry of TARP. Because the way TARP was designed, we have the ability to continue to execute these programs going forward, and we will do that. And as you have seen, we have added to the basic framework of the loan modification scheme a series of additional programs, again, to help improve the odds that we reach as many people as we can reasonably expect to reach to meet at this point. We are going to keep working on that.

And, Chair Warren, I will never stand before this body or any other body and over-claim for what this program is delivering. And, again, the reason why we have put out these numbers is because you can see, therefore, where servicers are getting better. You can see——

Chair WARREN. We must stop, Secretary Geithner. I am running over and it is not fair to my colleagues.

Mr. McWatters.

Mr. MCWATTERS. Thank you.

Mr. Secretary, if you could turn back the clock to the last quarter of 2008, what changes would you make to EESA and the TARP legislation? What can we learn from your experience?

Secretary GEITHNER. I do not feel in a position today to answer that question thoughtfully enough. Again, the best thing I can tell you today is that the reforms we proposed, that Congress is on the verge of enacting, would give us a much stronger set of tools for preventing these crises from happening and managing them with less cost to the taxpayer and the economy in the future. And what we are focused on doing is getting that passed and enacted and making sure it is followed by a set of well-designed constraints on risk-taking so that we can, again, tell the American people that we have a reasonable chance of preventing this from happening again. And that is what I am focused on at the moment.

On the details of how you design financial crisis rescue programs, the basic framework in that reform bill is a very strong framework, much better than what we had coming into this crisis.

Mr. MCWATTERS. Okay. By unanimous vote of the panel—it was a 4–0 vote, completely bipartisan with the recusal of Superintendent Neiman—two weeks ago, the panel adopted its report on the bailout of AIG. Even though the report exceeds 300 pages, allow me to read five of the key conclusions reached by the panel.

“The Government failed to exhaust all options before initially committing $85 billion in taxpayer funds to the bailout of AIG.

"The rescue of AIG distorted the marketplace by transforming highly risky derivative bets into fully guaranteed payment obligations.

"Throughout its rescue of AIG, the Government failed to address perceived conflicts of interest.

"Number four, even at this late stage, it remains unclear whether taxpayers will ever be repaid in full.

"Number five, the Government's rescue of AIG continues to have a poisonous effect on the marketplace."

I think it is only fair that you be permitted to respond.

Secretary GEITHNER. Well, I do not agree with those conclusions except perhaps for the fourth which says, as I say all the time, that the Government is still exposed to substantial risk of loss in AIG.

But it is worth just making the following observations.

This mess that we were handed in the peak of the crisis ultimately required, to stabilize the firm, commitments of, I think if you add them up together, something in the range of $180 billion. On the basis of the independent estimates of CBO and others, the ultimate risk of loss now has come down dramatically—it is still significant—but dramatically, a tiny fraction of that ultimate exposure because we have been so successful and careful in managing this process to lower the risk of the taxpayer in this case. And we are going to be continually focused on trying to make sure that we are bringing down the risk, we are selling off these companies to maximize the return and minimize the risk of loss. And we are working very hard, as you know, to make sure that we have a set of reforms in place and financial reforms that would prevent that from happening again and give us better choices.

And I am very confident, based on the strength of the provisions on derivatives, on risk-taking, on resolution authority, the basic package of these protections, that we will be in a position to both prevent and better manage mistakes like that that AIG and its shareholders, its board of directors, its executives made.

Mr. MCWATTERS. On a slightly different, but I think related note, when does the Administration plan to return Fannie and Freddie to the private sector?

Secretary GEITHNER. I am not sure I would frame it quite that way, but let me answer it this way.

We are deep into a process of examining what set of reforms should replace the current system we have in the housing finance market. Those will require fundamental changes to the GSEs, but we are not going to stop there because, as you know, the range of things that contributed to this mess went well beyond the basic incentive problems, moral hazard problems that pervaded the GSEs. I expect that after we pass this first wave of financial reforms, that we will be able to turn quickly, as will the banking committees, relevant committees in Congress, to examine those sets of options. And I have said publicly that we expect to recommend a set of broad reforms sometime early next year, which means roughly six months from now.

Now, it is very important to point out that the losses that we still face in these institutions are losses we inherited. They are the product of the judgments made before the Government stepped in. At our insistence, they have put in place much more conservative underwriting standards. They are charging more for their guarantees to remedy some of the mistakes they made. They are bringing down risk in the rest of the institution quite significantly. So the institutions today are being run much more conservatively, as you would expect.

I think we are going to find—I hope we will find—quite broad support in Congress, Republicans and Democrats, for putting in place the kind of fundamental reforms that these institutions and the housing market obviously needs.

Mr. MCWATTERS. Thank you, Mr. Secretary. My time is up.

Chair WARREN. Thank you.

Mr. Silvers.

Mr. SILVERS. Mr. Secretary, I want to take you back for a moment to your response to a question from my fellow panelist who cited home ownership levels from 1965 to 1995 as something we ought to be aspiring to. And you responded something to the effect of that is exactly where we are trying to get to.

I want to give you the opportunity to modify that answer.

Secretary GEITHNER. To rephrase my response?

Mr. SILVERS. Yes, because from 1965 to 1995, that flat number reflected essentially the systematic denial of credit to communities of color. That cannot be our goal to return to that time.

I would also like to give you an opportunity to modify your response in light of what has troubled me about our discussion about housing throughout this morning, which is that the shift to unemployment-driven foreclosures, which I think is evidenced in your exchange with Superintendent Neiman, around the question of people's ability to pay. It cannot be our policy that we think that people who are the victims of long-term unemployment should be thrown out of their homes. So I would like you to——

Secretary GEITHNER. Excellent questions.

Mr. SILVERS [continuing]. Give yourself some time to clarify these matters.

Secretary GEITHNER. Excellent questions. And I agree with the way you characterized that little history of evolution in our financial system and how it met the broader needs of the country.

What I want to say is this. Our policies are not designed to sustain home ownership rates at a level that we think is not sustainable. It should not be our objective, cannot be our objective. And I think it is true that although there have been huge gains from the broad evolution of our financial system in meeting the needs of not just low-income and minority communities, but more generally across this country, it played a huge role in financing innovation among small businesses too. We are going to do our best to preserve those gains but not leave the country and our financial system and the economy vulnerable to the excesses that we saw.

Of course, as you pointed out, those big gains in access to credit that our system generated also came with huge opportunities for predation and fraud and abuse. That happened not because of the presence of regulation. It happened because of the absence of regulation on a whole range of institutions that were allowed to provide credit without basic protections. One of the virtues of this reform bill is it protects that.

Now, we do not have a perfect judgment about what is a sustainable rate of home ownership. What we do know is we had a whole range of incentives across the American financial system that were designed to encourage home ownership. And I think those, probably on balance, went a little too far.

What I think is important to recognize in our broad housing policies—and this will be true for our reforms to the GSEs and the housing finance market—we are going to try to remedy some of those problems in balance, try to preserve what is fair and important in trying to make sure that Americans have access to affordable housing programs, but not try to sustain or recreate a level of investment in housing that was part of this basic crisis.

Now, having said that, I have forgotten your second question.

Mr. SILVERS. Unemployment.

Secretary GEITHNER. Yes. Thank you for doing that.

We have done a continuous series of innovations and changes to these programs from the beginning, as you heard me describe. And one of the things we did, starting earlier this year, was introduce programs that are designed to directly help the unemployed reduce the risk that they would lose their home, but also to shift the balance of benefits in this program to encourage greater principal reduction.

And also, much like what I said to Mr. Neiman on the small business credit side, we have introduced a program where we give States hardest hit by the crisis, States with the steepest drops in house prices, highest levels of unemployment, or a combination of those two factors, access to significant resources to finance a range of programs to help the unemployed in their States, to help encourage greater principal reduction, a range of other types of innovative programs at the State level.

That is a sensible use of public policy, a sensible use of resources again, because as you said, unlike the early stage of the foreclosure crisis, the principal driver we see today is the result of the fact that unemployment is still so high.

Mr. SILVERS. Two points in response, Mr. Secretary. One is I think there is an issue of scale in relation to the unemployment problem. The scale of the resources simply is not adequate. I think we have models, the HEMAP program in Pennsylvania, for how to do that at scale. You have got three months. I hope you are thinking about that.

Secondly, in relationship again to the question of the level of homeownership, I think the data shows very clearly, contrary to I think what some of my colleagues would say, that we made significant progress in reversing decades of redlining during the 1990s, and that starting around 2002–2003, we saw a set of unsustainable and exploitive practices take over. I think that kind of gives you a way of marking what constitutes a sustainable level of home ownership and what does not.

Secretary GEITHNER. I think that is a very good perspective, and that is one good way to think about it.

But you also have to look at the combination of all sorts of other incentives we created and it is hard to find the right balance.

Can I correct one other thing I said, Ms. Warren?

Chair WARREN. Yes, Mr. Secretary.

Secretary GEITHNER. I said at some point in my remarks earlier that 8 million Americans were out of work because of the crisis. The number is about double that, but roughly 8 million have lost their job in this crisis.

Chair WARREN. Thank you, Mr. Secretary.

Dr. Troske.

Dr. TROSKE. I guess I would like to clarify that I certainly do not believe that we should have a process which denies people ownership of a home or financing for a home by any reason other than income. But I do think it is important to point out that no one should be homeless. But those are two different things. And I think it is also important to recognize that not everyone needs to own a home. Renting a home is a perfectly viable option. And I think it is important to match people correctly to the ownership situation that best fits their financial situation.

So one of the things I was suggesting is that maybe programs that help move people out of a situation which is not appropriate, given their financial situation, into one that is appropriate, even if it is not owning a home, but instead renting, which seems like a perfectly viable option in a number of other places in this world. What might be a better use of resources than trying to keep people in their homes, especially since our experience with loan modification and programs designed to keep people in their homes in the Great Depression suggests that they are not particularly effective? So maybe you could comment on that.

Secretary GEITHNER. I have some sympathy for that perspective, and we do have a set of programs that we are supporting that are consistent with that basic recognition and reality.

But I think it is important to step back for a second and recognize the things we got wrong in this area because they should guide how we think about reform going forward. Again, not to oversimplify it, but the two most damaging mistakes that Washington made in this crisis were, one, not to constrain risk-taking in the mortgage finance market by the GSEs, and the other was not to provide Americans basic protections against predation, fraud, and abuse in the credit market. Those were devastating in their consequences. We are still living with the consequences of that. We are going to be living with them for a long period of time.

And a fundamental responsibility of Washington is to try to help make sure that we are repairing those mistakes and helping people who were damaged by those mistakes have a chance to repair their lives in that context. And that is a responsible, good use.

Now, we recognize that we cannot reach everyone, and different solutions are going to be appropriate for different people, and that we have got a lot of challenges ahead in that area, but those two mistakes are things that we have to make sure we fix in financial reform and I am very confident we are going to be able to do that.

Dr. TROSKE. So maybe we will stay on the housing market for a minute to build on some of the comments that have been made previously.

Do you think the Federal Government should be involved in a significant way in the future of financing in the mortgage market? Does the Federal Government have any particular advantage over the private sector which would suggest that the Federal Government needs to maintain a role in that sector?

Secretary GEITHNER. Excellent question. I have testified on this before and I do not want to change or alter the basic framework I have laid out in that context. So I would say it this way.

I think there is going to be a good public policy case for the Government still promoting the objectives of access to reasonable housing options for low-income Americans. That is an important objective. I believe in that objective. We are going to make sure we are doing it as carefully as we can going forward.

I also believe it is likely that we will determine that it is going to be an appropriate role for the Government in providing some form of guarantee to help make sure that their broader housing finance markets are able to provide credit to housing in recessions and downturns. That is a very important basic debate. We are going to have that debate when we talk about reforms. But having looked at a variety of different models in our experience, I think that we are likely to conclude that there is going to be a reasonable case for retaining a limited role for the Government providing that kind of basic guarantee. How to do that is a challenge. We want to make sure that where you do that, firms have to pay for that guarantee and that the firms that provide that guarantee run with adequate capital against risks. But I want to be careful not to add to anything I have said in the past about this, and these are the kind of questions that we are looking at in the context of reform.

Dr. TROSKE. So maybe I can finish up with one more question.

You seem to be much more positive about the effectiveness of TARP than the American public. Could you tell me why you think that is? What do you know that the American public is not aware of, and why has that not been conveyed to the American public?

Secretary GEITHNER. I think that the American public was left with the impression that the Government of the United States came in and wrote checks for $700 billion to our Nation's largest financial institutions and that they will never see that money again. And that initial perception that was created by the critics of this program hardened and has been a challenge, as you on this committee have found, particularly those who were here from the beginning.

The reality, of course, is very different. As I said, we have only put out about half of that authority. We have more than half back. This administration came into office, did not write a single check to our Nation's largest banks. We wrote $7 billion of checks to small community banks across the country. And as I said, this program on the bank side is generating a very substantial, positive return to the American people, and we are going to return hundreds of billions of dollars of authority—how often does that happen in Washington—to the Congress so they can help reduce our future deficits and meet our long-term needs.

Those are the facts and realities of this program, and if you compare that record, not just against the expectations of the critics, not just against the expectations of the architects, but against the experience of this country in past crises or the experience of almost any major country in a crisis, it is a remarkably effective program, highest return on the use of a dollar of taxpayers' money than I think almost anything the Government has done in this crisis.

Now——

Chair WARREN. Mr. Secretary, this is your time, and we are over the time. I still want to give Superintendent Neiman a chance for a last round of questions. So if you will bear with us. We are past the time. It is your time.

Secretary GEITHNER. But acknowledging that this caused a huge amount of damage, we are going to be living with the aftershocks of that for a long time, and we are still in the beginning of repairing that basic damage and it is going to take more time.

Chair WARREN. Thank you, Mr. Secretary.

Superintendent Neiman.

Mr. NEIMAN. As I mentioned in my opening statement, Congress is finalizing financial reform that will have implications for decades, both domestically and internationally. Many of us are glad to see the U.S. acting as a first mover in regulatory reform. I have been told on a number of occasions by foreign government officials how they are very pleased that we are moving ahead, though they probably are not saying this as publicly as they should.

I am especially proud of particular areas where we are ahead of the rest of the world, things like the Volcker Rule, like proper alignment of executive pay and risk. However, we all know that acting as a first mover does raise issues around global competitiveness, regulatory arbitrage, and regulatory gaps around the world.

Would you mind sharing with us the standard that you apply when determining when the U.S. must lead and when the U.S. must act in global concert?

Secretary GEITHNER. We are trying to do so together. We are acting, as you know, to fix the things we got wrong, but at the same time we laid out our basic objectives for reform, we negotiated internationally a broad consensus on a set of broad objectives internationally that would parallel very much the basic strategy we adopted here. And you are going to see when the G–20 leaders meet in Toronto on Saturday and Sunday a remarkable commitment across the major economies to that set of basic principles for providing better oversight, better transparency and disclosure, better protections against risk-taking on a more even standard across the major institutions and markets.

We could have decided to move here and then try to put in place high standards here and try to pull the world to those standards over time. We decided to move together so we would reduce the risk that risk would just move from the United States to those other countries.

Now, we have a very difficult challenge ahead in negotiating a new set of capital standards for the globally active banks, and that will be the critical test of our capacity again, to pull the world to higher standards. But we come to that with a remarkably strong position because we were able to move so quickly in the United States to recapitalize our system with private capital to replace the Government's investments early and, therefore, our firms on most measures have less leverage, more capital, more of the kind of capital that you need, common equity, against future losses. And that gives us a very strong position in those discussions.

But again, the best way for us to shape that consensus is to make sure that we come to the table, having acted to fix the things we got wrong in the United States—and I believe that the reforms Congress is about to enact will be a good model for the world and will give us enormous credibility in trying to, again, pull the world to those higher standards.

Mr. NEIMAN. Are there other examples like capital where the U.S. has to act as a first mover if there is not global concert in that particular area?

Secretary GEITHNER. Again, we are going to try and make sure we are moving in parallel. Derivatives is another good example. Any financial product of consequence today can move very quickly to seek the weakest regulation. In the basic standards of disclosure and transparency that have been such a source of interest for this committee over time, again, we want to make sure that all these firms and all these markets are operating under much more rigorous standards for disclosure and transparency. Otherwise, the risk will move to where it is dark and that will leave us with more risk in the future.

Mr. NEIMAN. My time has expired.

Secretary GEITHNER. There are many other examples, though, but you are right about the basic imperative.

And again, we are going to try to make sure that we dramatically strengthen the competitiveness of the U.S. financial system by, as we have done well in the past, making sure that we put in place very high standards for protection for investors in the U.S. marketplace. And we are going to do everything we can to make sure the world joins us in that cause.

Chair WARREN. Thank you. We now bring to a conclusion our 21st hearing of the Congressional Oversight Panel. We want to thank you, Mr. Secretary, for being with us today.

The record will be held open for any additional questions.

With that, this hearing is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[The responses of Secretary Geithner to questions for the record from the Congressional Oversight Panel appear on the following pages.]

Questions for the Record from the Congressional Oversight Panel
Congressional Oversight Panel Hearing on June 22, 2010
Questions for the Honorable Timothy F. Geithner
Secretary of the Treasury

Questions for the Record from Elizabeth Warren, Chair, Congressional Oversight Panel

1. From its first report on foreclosure mitigation in March 2009, the Panel has expressed serious concerns about the size and scope of HAMP and has raised questions about whether the relief afforded to homeowners would result in foreclosure avoidance or merely foreclosure delay. The data in the 15 months since then have confirmed that the program is clearly troubled. While Treasury has made numerous announcements, it has yet to demonstrate a track record of strong results. What is the status of the various initiatives and programmatic changes Treasury has announced in 2010? When will they be fully implemented?

A: We disagree with your conclusion that HAMP is "clearly troubled." While we continue to make improvements and additions to our housing programs, HAMP is an effective program that has provided immediate relief and helped hundreds of thousands of responsible American homeowners avoid foreclosure, stay in their homes, and get back on their feet. The Obama Administration took office in the middle of the most serious housing crisis in decades. Home prices had fallen for 30 straight months. Stresses in the financial system had reduced the supply of mortgage credit, limiting the ability of Americans to buy homes. And millions of responsible American families who were making their monthly payments—despite having lost jobs or income—had seen their property values fall, and were unable to sell or refinance at lower mortgage rates. The combination of falling home prices and economic contraction had dramatically increased the financial strains on many responsible homeowners.

At the time, there was no consensus among loan servicers about how to respond to responsible borrowers who were willing to continue making payments but were in need of some mortgage assistance. There were no accepted timeframes for servicer decisions. Servicers were paralyzed by the need to seek approval from investors on an individual, mortgage-by-mortgage basis. And, perhaps most critically, there was no affordability standard for monthly mortgage payments. Before HAMP, there was no program of any significant size or scope, public or private, to modify mortgages for affordability. As a result, the solutions offered by servicers often merely added unpaid interest and fees to the mortgage balance, resulting in higher—not lower—payments for homeowners.

During its first month in office, the Administration took aggressive action. It announced the Homeowner Affordability and Stability Plan, which provided numerous forms of relief, including: support for Fannie Mae and Freddie Mac to maintain broad availability of affordable mortgage credit; increased flexibility for Fannie Mae and Freddie Mac in refinancing mortgages to provide homeowners with lower monthly payments; tax credits to support development of affordable housing; and support to state and local housing finance agencies. HAMP was an important part of this comprehensive response. It was designed to offer responsible American homeowners reduced monthly mortgage payments that are sustainable over the long-term.

Through HAMP, 1.3 million homeowners have already received real payment relief (a median monthly payment reduction of $500) and nearly 400,000 have had their loans permanently modified.

Based on survey data from the eight largest servicers, homeowners unable to complete a HAMP modification are still receiving help, and in more than 85% of cases, have been able to avoid foreclosure. Preliminary results show that approximately one-half of homeowners not ultimately converting to a permanent modification have received some form of private-sector modification and the majority has avoided foreclosure through some alternative solution. These numbers help demonstrate that HAMP has changed the servicing industry in a way that is providing broader access to affordable modification options for homeowners both inside and outside of the HAMP program.

Within the past few months, we have announced details of key enhancements including incentives for principal reduction and unemployment forbearance. In conjunction with HUD, the Administration has announced a Federal Housing Administration (FHA) refinance option for underwater borrowers. We have also taken a number of steps to enhance HAMP, including prohibiting foreclosure referrals until a borrower has been fully evaluated for HAMP, simplifying required documentation and making critical improvements to complaint escalation and resolution processes. We are already beginning to see progress from these efforts and believe that HAMP is poised to meet the continuing demand.

These improvements and new programs include:

- Second Lien Modification Program (2MP) – Seven servicers, representing approximately 50 percent of all second liens, have enrolled to modify second liens in their portfolios when a corresponding first lien is modified under HAMP. Wells Fargo, Bank of America and JPMorgan Chase have all begun 2MP modifications in cases where they hold both the first and the second lien. The remaining participating servicers are scheduled to begin in late August 2010.

- Home Affordable Foreclosure Alternatives Program (HAFA) - Incentives for short sales and deeds in lieu of foreclosure, included in HAFA, became effective on April 5, 2010. We expect to begin reporting this activity in the fall.

- Home Affordable Unemployment Program (UP) – Mandatory forbearance for qualified unemployed borrowers becomes effective August 1, 2010.

- Principal Reduction Alternative (PRA) – We expect this to be effective by the fall - servicers will be required to evaluate every loan with a loan to value in excess of 115 percent to compare the NPV of a modification including principal reduction to the NPV of a standard HAMP modification. However, to encourage principal reduction approaches as quickly as possible, servicers are eligible for financial incentives for any principal reduction completed now as well.

2. The Panel's April 2010 report recommended that Treasury articulate clear goals and metrics by which the foreclosure mitigation programs could be judged.[1] SIGTARP and GAO have both made similar recommendations. To date, there has been no independent metric set out in advance by which success—or failure—of the foreclosure prevention program might be evaluated. Instead, Treasury has indicated that the program would help 3 to 4 million borrowers, which seems to mean only that this is the number of borrowers who will be offered a modification during the life of the program, not the number of borrowers actually receiving a modification or the number of borrowers experiencing long term success in a modification.

- **Why has Treasury refused to specify any metrics to evaluate the housing programs?**
- **Will Treasury identify any clear metrics for evaluating the success or failure of the housing programs, as recommended by COP, SIGTARP and GAO?**
- **What number of temporary modifications do you believe are necessary for the programs to be considered a success?**
- **What number of permanent modifications do you believe are necessary for the programs to be considered a success?**
- **What percentage of permanent modifications must still be in place at the end of five years for the programs to be considered a success?**
- **Treasury has modified the foreclosure program, but it has provided no metrics to determine whether those program changes are effective. Will Treasury identify any clear metrics for evaluating the success or failure of the changes that it has made to the housing programs?**

A: In February 2009, Treasury set a goal to "offer reduced monthly payments for up to three to four million at-risk homeowners," providing these homeowners with a second chance to modify their mortgages and "avoid foreclosure." This projection was based on the best available estimate at that time of the number of HAMP – eligible households that were likely to require assistance during the four-year duration of the program. As economic conditions have changed, Treasury has enhanced programs to address the impact of conditions such as increased unemployment and decreased home values on borrowers (e.g., unemployment forbearance, principal reduction). These enhancements are designed to ensure that the HAMP program can reach as many distressed borrowers as feasible.

Since the program began, the Administration has consistently strived to not only meet this baseline goal, but exceed it by translating this initial help into sustainable outcomes for borrowers that allow families to remain in their homes or avoid foreclosure through transitioning to other housing through efforts like the Home Affordable Foreclosure Alternatives program (HAFA). We believe that the most significant measures of success for the program are not just how many borrowers start trial modifications or even permanent modifications, but whether families are able to avoid foreclosures and how effective the program is in stabilizing neighborhoods and the housing market.

Additionally, transparency in the program's public reports suggest a number of other performance measures that go beyond whether a homeowner has received a permanent

[1] Congressional Oversight Panel, *April 2010 Oversight Report: Evaluating Progress on TARP Foreclosure Mitigation Programs*, at 95-97 (Apr. 14, 2010) (online at http://cop.senate.gov/documents/cop-041410-report.pdf).

modification. Since the first Servicer Performance Report in July 2009, these public reports have grown as more data becomes available and have become far more indicative of the effect HAMP has had galvanizing the mortgage industry and proliferating affordable solutions for homeowners.

The monthly reports state the number of trial offers, trials started, and permanent modifications completed each month since November 2009. The monthly reports also show servicer-specific progress – providing the percentage of delinquent loans against offers, trials, and permanent modifications. The report also provides information by servicer on the percentage of trial modifications converted to permanent modifications. These comparative performance metrics by servicer provide a good measurement of the program's progress. Treasury plans to continue reporting monthly these program performance metrics.
Lastly, with lessons learned from the past several months of full capacity operations, Treasury is increasing the number of performance metrics each month. For example, Treasury is now reporting data on servicer performance, including time to answer incoming borrower calls, time to process HAMP applications from homeowners, and time to resolve complaints raised by third parties (i.e., counselors, attorneys and government agencies).

3. Since the housing crisis began in 2007, the problem has evolved. New layers of borrowers have entered foreclosure, from subprime borrowers, to unemployed homeowners, to discouraged homeowners who see no reasonable possibility of paying off their homes. In the latter category, one-fourth of all mortgage holders now owe more money than their homes are worth and websites like youwalkaway.com clearly demonstrate that a number of families are considering that option. As the crisis continues to evolve after October 3, 2010, what authority will Treasury have to make changes to the foreclosure mitigation programs?

A: Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Treasury's authority to initiate new programs under the Emergency Economic Stabilization Act of 2008 (EESA) has expired. In addition, after October 3, 2010, Treasury will no longer be authorized to obligate new funds under existing programs, but will still have some limited flexibility to modify existing programs, subject to restrictions set forth in its contracts with servicers and the apportionment in place as of October 3, 2010.

Similarly, for the Housing Finance Agency Innovation Fund for the Hardest-Hit Housing Markets ("HFA Hardest-Hit Fund"), the states are permitted to introduce new programs within their individual state allocations, provided, of course, that any such new programs meet the terms of the contracts with the related state and the other requirements of EESA.

4. The Panel held a hearing in March with Citigroup CEO Vikram Pandit and Assistant Secretary for Financial Stability Herb Allison. In a question for the record of that hearing, the Panel asked Assistant Secretary Allison about "the unique challenges and potential remedies for unwinding a foreign financial institution with significant U.S. operations or a U.S. financial institution with significant overseas operations". In his response, Assistant Secretary Allison noted the ongoing work of the G-20 leaders and the Financial Stability Board they established to "promote the implementation of effective regulatory, supervisory, and other financial sector policies".

In the aftermath of TARP and other rescue efforts in the United States, how do we assure that very large multinational financial institutions do not exploit the implicit guarantee that this experience has served to confirm by moving their operations to more lenient countries?

A: Domestically, the Dodd-Frank Wall Street Reform and Consumer Protection Act gives the federal government the authority to shut down and break apart large non-bank financial firms whose imminent failure might threaten the broader system. Modeled on the FDIC resolution process, this resolution authority closes a gap that severely limited the federal government's options during the crisis. Internationally, we are working to achieve high-quality standards and a level playing field. The Administration has taken a leadership role in the G-20 to bring all global institutions and markets within a more transparent regulatory system. G-20 Leaders have committed to act together to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter derivatives market and to create more powerful tools to hold large global firms accountable for the risks they take. Standards for large global financial firms should be commensurate with the cost of their failure. Now we are working to reach agreement internationally on reducing leverage and raising capital requirements, improving both the quantity and quality of capital. While new measures must be phased in over time so as not to interfere with the flow of credit, establishing those rules now can be an important source of certainty and confidence.

4a: How can we prevent very large financial institutions from taking advantage of the weakest regulatory environments to take excessive risks?

A: The United States has played a leadership role in driving an ambitious reform agenda internationally. G-20 Leaders have committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage. Internationally, we have developed and begun implementing sweeping reforms to tackle the root causes of the crisis and transform the system for global financial regulation. Substantial progress has been made in strengthening prudential oversight, improving risk management, strengthening transparency, promoting market integrity, establishing supervisory colleges, and reinforcing international cooperation. We have enhanced and expanded the scope of regulation and oversight, with tougher regulation of over-the-counter (OTC) derivatives, securitization markets, credit rating agencies, and hedge funds. We continue to work together in the G-20 and the Financial Stability Board to reach consensus on achieving more rigorous global financial regulation and supervisory procedures. For example, at the Toronto Summit in June, G-20 Leaders reaffirmed their support for a strengthened capital regime, underscoring that banks should hold enough capital to absorb losses of the magnitude arising in the recent financial crisis. Given the depth of the recent recession, there is a high bar for bank capital. The Basel Committee on Banking Supervision is working hard to reach an agreement on improved capital standards in time for the Seoul Summit in November.

4b: What can you tell us about the progress that the international organizations are making in establishing a coordinated process for unwinding multinational banks that are facing insolvency?

A: We have advocated reforms to make the global financial system safer for failure. Our objective is to ensure that taxpayers will no longer bear the costs of financial crises. Our regulatory reform legislation expands the FDIC model for winding down failing banks to include authority for dealing with other types of financial institutions, and will ensure that the financial industry – and not taxpayers – bears the costs of responding to a financial crisis. In Toronto, in late June, G-20 Leaders committed to implementing national resolution authorities based on the Basel Committee's work. That work has identified improvement of national resolution systems, better cross-border management mechanisms and convergence of national laws as the most effective way forward. Leaders also called on the Financial Stability Board to consider and develop concrete policy recommendations to effectively address problems associated with, and resolve, systemically important financial institutions in time for the Seoul Summit. G-20 Leaders also have supported firm-level rapid resolution plans to enable firms to facilitate resolution. Firm-specific crisis management groups are being established as well.

5. At the Panel's March hearing on Citigroup, both Citigroup CEO Vikram Pandit and Assistant Secretary for Financial Stability Herb Allison testified that the firm was not on the brink of failure in November 2008, despite the fact that Treasury provided it with $20 billion in capital on top of the $25 billion it provided in October 2008.

- **While these decisions were made by the prior administration, do you have a view on Citigroup's financial position in November 2008?**
- **If it was not on the brink of failure, why was it necessary for the government to provide Citigroup with an additional $20 billion in capital and a guarantee on a portion of potential losses on a $301 billion pool of assets? If it was on the brink of failure, why was bankruptcy (and/or its banking equivalent) not an option?**

A: By way of clarification, at the Panel's March hearing on Citigroup, in response to a question as to whether Citigroup was a failing institution on November 21, 2008, Assistant Secretary Allison testified as follows: *"I think that Citi, and a number of other banks -- many banks -- were on the brink of failure had the system not been underpinned by actions of the government - including the Federal Reserve, as well as the U.S. Treasury."*

Although the October 2008 announcement of the initial investments under the Capital Purchase Program (CPP) was well received, the outlook for the U.S. economy and Citigroup continued to deteriorate in subsequent weeks. For example, the credit default swap (CDS) spread on 10 year senior Citigroup debt fell from 354 basis points on October 13, 2008 - the day before the announcement of Treasury's CPP investment - to 161 basis points the following day. The spread was back up to 378 basis points on November 21, 2008 - the last trading day before the announcement of assistance to Citigroup under what became known as the Targeted Investment Program (TIP) and the Asset Guarantee Program (AGP). At the same time, broader measures of risk throughout the financial system were also highly unstable. The VIX Volatility Index fell from 70 on October 10, to 55 on October 14, but was back up to 73 on November 21. Due to the deterioration in confidence, there was concern that, without government assistance, Citigroup would not be able to obtain sufficient funding in the market over the following days.

During the week of November 17, 2008, as the outlook for the U.S. economy and the market's perception of Citigroup continued to deteriorate, representatives of the Federal Reserve, the FDIC, Treasury and Citigroup participated in meetings and conference calls to discuss Citigroup's financial position, as well as the logistics of a coordinated government response.

As the Federal Reserve observed in recommending a systemic risk determination regarding Citigroup's insured depositary institution subsidiaries, a failure to act to reestablish confidence in Citigroup by providing additional liquidity and an asset guarantee program would have had a significant adverse effect on U.S. and global financial markets. A further deterioration of Citigroup would have led investors to doubt the ability and willingness of U.S. policymakers to support U.S. banking institutions and financial markets, notwithstanding Treasury's prior CPP investments. As a result, funding markets would likely have frozen, and other large U.S. banking organizations would have been extremely vulnerable to a loss of confidence by wholesale suppliers of funds. Investors would have been concerned about direct exposures of other financial firms to Citigroup, and might have begun to doubt the financial strength of other large U.S. financial institutions that might have been seen as similarly situated, likely weakening overall confidence in U.S. commercial banks.

More generally, given Citigroup's substantial international presence, global liquidity pressures would likely have increased and confidence in U.S. assets more broadly could have declined. Moreover, in the event that Citigroup would have been unable to obtain sufficient funding in the market in that period, losses on Citigroup paper could have led some money market mutual funds to "break the buck." All of these effects would likely have caused investors to raise sharply their assessment of the risks of investing in U.S. banking organizations, making it much less likely that such institutions would be able to raise capital and other funding despite the efforts of Treasury under the CPP.

The worsening of the financial turmoil that would likely have resulted would have further undermined business and household confidence. In addition, with the liquidity of banking organizations further reduced and their funding costs increased, banking organizations would likely have become even less willing to lend to businesses and households. Beyond the much greater severity of the financial crisis that would have ensued, these effects would have contributed to weaker economic performance, higher unemployment, and reduced wealth, in each case materially.

As a result of these conversations, and, in consultation with the Federal Reserve and the FDIC, Treasury concluded that given the state of the U.S. markets, the economy, and the size, importance and inter-connectedness of Citigroup, additional action was necessary to promote financial stability, and that failure to act would have severe repercussions on global financial markets and the economy.

Regarding your question about the bankruptcy option, it is important to note that the actions taken to combat the financial crisis were, in part, the result of a fundamental failure of the structure of financial regulation. Regulators did not have the tools to break apart or wind down a failing financial firm without putting the entire financial system at risk. The FDIC's resolution authority was limited to insured depository institutions and did not include their holding companies. To its credit, Congress did not wait for the next crisis before enacting the common sense reforms we needed. Congress passed, and President Obama signed, the Wall Street Reform and Consumer Protection Act of 2010, which eliminates "Too Big to Fail" by providing the ability to shut down and break apart a failing financial firm in a safe, orderly way – with the FDIC as receiver – without putting the rest of the financial system at risk, and without asking the taxpayers to pay a dime. And in mitigating the risk to U.S. financial stability the same mechanism will also significantly mitigate the contagion risk associated with the failed firm's cross-border contractual obligations.

6. One of the recommendations in the Panel's March report on GMAC (now Ally Financial) was that "Treasury should consider whether it is in the taxpayers' interest to consider promoting a merger with GM", because combining GM and Ally Financial's auto finance arm would likely create more value than the government could realize if these two entities remained separate.[2] It was recently reported that GM is now considering teaming with one or more major financial institutions to compete with Ally Financial's auto finance business.[3] While Treasury has stressed that it is not interested in taking an active role in the management of either company, have you considered the implications of merging GM and the auto finance arm of Ally Financial? If so, please comment on the merits or demerits of this approach. If not, please explain why not.

A: It would be inappropriate for Treasury to speculate publicly regarding any particular transaction involving GM or Ally. Treasury has previously articulated the principles it will follow in managing its investments. A merger would first require a determination by the boards of directors of each company that it is in the interest of each company and all its stockholders, not just Treasury. Each board operates independently and is not directed by Treasury.

Treasury is committed to maximizing taxpayer returns on its investments. To that end, Treasury will continue to monitor and evaluate the performance of GM and Ally with a view toward determining the appropriate method and timing for divesting Treasury's interests in each company. Treasury has previously announced guidance with respect to its role in the exploration of a possible initial public offering by GM, and Treasury will continue to entertain a range of strategic alternatives to exit its stake in Ally as soon as practicable, including both a public or private sale of Treasury's interest.

6a. What is Treasury's view with respect to reports that GM is considering an alliance with other providers of auto finance? What impact could this competition have on Ally's ability to repay the government?

A: In July 2010, GM announced that it entered into a definitive agreement to acquire AmeriCredit. In line with the principles that guide the government's role as a shareholder,

[2] Congressional Oversight Panel, *March 2010 Oversight Report: The Unique Treatment of GMAC Under TARP*, at 121 (Mar. 10, 2010) (online at http://cop.senate.gov/documents/cop-031110-report.pdf).
[3] David Welch, *GM Said to Decide Against Credit Unit, May Team Up With Banks*, Bloomberg Businessweek (July 9, 2010) (online at http://www.businessweek.com/news/2010-07-09/gm-said-to-decide-against-credit-unit-may-team-up-with-banks.html).

Treasury was not involved in this decision. GM is not required to seek Treasury's approval for its investments, but Treasury was notified of the decision.

Treasury is committed to maximizing taxpayer's returns on its investments in both GM and Ally. However, consistent with our principles of not interfering in the day-to-day operations of either GM or Ally, decisions with regards to acquisitions, business alliances or customer relationships will be decided by the companies' management and boards of directors.

Questions for the Record from Richard Neiman, Member, Congressional Oversight Panel

1. At our hearing, I appreciated you stating that Treasury would work to provide more information to the public about the terms of the non-HAMP modifications received by homeowners who are removed from the HAMP program. The panel would be grateful for your indication of what type of information can be provided and whether such information can be made available by the publication of the Panel's July monthly report on July 14, 2010. It is important that this disclosure provide sufficient information for the public to be able to assess whether these non-HAMP modifications are actually making homeowners better off.

Data on proprietary, or "non-HAMP," modifications is already collected for two separate publications: by HOPE NOW for its monthly Industry Extrapolations and Metrics report; and by the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) for their quarterly Mortgage Metrics report.

The HOPE NOW report contains summary data that shows workout plans and proprietary modifications by month, broken down by prime and subprime and by owner occupancy. The OCC-OTS report has more detailed statistics on the types of proprietary modifications, categorized by risk category, by investor and product type, and by the change in monthly principal and interest payments achieved through modification. Additionally, the report shows the performance of those modifications over time, including re-default rates by investor type and by the change in monthly payments.

The OCC-OTS report helps to elucidate the change that HAMP has brought to the quality of loan modifications offered to distressed homeowners. Nearly half of mortgage modifications done in the quarter just prior to HAMP left mortgage payments either unchanged or higher than they were before modification. After HAMP began, the number of modifications that did not reduce payments fell dramatically and now comprises just 12.6 percent of all modifications.

The Making Home Affordable monthly public reports will continue to report on the number of homeowners who receive non-HAMP modifications after applying for HAMP.

2. Your directness in stating that the inability to verify income through collected documentation was the main driver for HAMP participants in trial modifications to ultimately be removed from the program was appreciated. Was the problem primarily that the homeowners' documentation revealed that they had more income than they initially stated or less? Or did the servicers perhaps fail to fully review documentation

from homeowners? What steps has Treasury taken to ensure that servicers have fully reviewed all borrower documentation and that documents submitted are not lost?

A: As I noted during the hearing, we made a choice last summer to allow homeowners to receive a trial modification based on stated income in order to provide immediate assistance to an unprecedented number of struggling homeowners. Because of that decision, we have thus far provided over one million homeowners an opportunity to reduce their mortgage payments and avoid foreclosure. However, we found that servicers were having trouble converting a large number of these homeowners because they found significant discrepancies between stated and verified incomes – discrepancies that often could not be easily reconciled because they had implications for homeowner eligibility in the program.

As we worked with servicers to deliver modification decisions during the conversion campaign we found that both over- and under-statements of income were occurring. However, as the recent MHA Public Report shows, one of the major reasons for trial cancellations was that homeowners' verified debt-to-income was less than 31 percent. In these cases, homeowners began a trial modification with a lower stated income that qualified them at the 31 percent threshold. Once that income was determined to be higher based on full documentation, many homeowners were then found to have monthly payments lower than 31 percent of their gross monthly incomes.

The strongest assurance that servicers are appropriately reviewing all documentation prior to cancellation is the work of our compliance activities. The Compliance Agent for HAMP is Freddie Mac, which has established a separate, independent division to conduct the compliance activities: MHA-C. MHA Compliance is designed to ensure that servicers are meeting their obligations under the HAMP Servicer Participation Agreement (SPA) and Program guidance, and utilizes a variety of compliance activities to assess servicers from different perspectives or "touch points." Two of these activities specifically serve to evaluate the design and effectiveness of the processes servicers use to manage documentation and validate borrower income.

Loan file reviews of a servicer's non-performing loan portfolio are performed to assess completeness of relevant documentation and appropriate loan modification decision making. This includes reviews of loans which have successfully converted to a permanent modification to ensure they meet the HAMP guidelines, as well as loans that have not been offered HAMP modifications to ensure that the exclusion was appropriate ("Second Look"). In both cases, one of the objectives of the review is to ensure that servicer loan files contain appropriate documentation, including documentation submitted by the borrower. Servicer calculation of borrower income is assessed to ensure that the borrower was properly evaluated against the HAMP housing debt to income threshold.

Second Look results from January and February show that an average of 11.4 percent of loans that were not offered a HAMP modification did not meet the debt to income threshold. The Compliance Agent disagreed with an average of 3.9 percent of these decisions, which is consistent with the overall percentage of disagreements for all reasons loans are not offered a HAMP modification.

Implementation on-site reviews cover the servicer's overall execution of the HAMP program. Areas covered include, among other things, solicitation, eligibility, underwriting, document management, payment processing, reporting, complaint management and response, and governance. During these reviews, servicer controls over document intake, scanning, and management are assessed. Additionally, controls over the calculation of borrower income and housing debt are assessed, and specific loan files are reviewed to ensure the servicer has appropriate documentation and conducted an appropriate HAMP evaluation process.

The results of our compliance activities with respect to document management and servicer calculation of borrower income indicate that where errors have occurred, they were equally likely to relate to over- or under-reporting of income. Where servicers have been found to require improvements in either area, Treasury has taken actions that range from re-evaluating individual loans to changing servicer processes and implementing additional procedures and tools to address the issue noted.

3. You were also direct in stating that mortgage servicers have done a terrible job as HAMP program participants. Given this assertion, which many share, how can we really trust the servicers' position that homeowners should be removed from the program? Some homeowners indeed may not have submitted documentation that backs up their stated income, but isn't it just as likely that servicers are not adequately reviewing the documentation that they are receiving?

A: Because of the substantial implementation burdens associated with ramping up such an unprecedented foreclosure mitigation program, servicers did experience issues with the transmission and storage of borrower documents. Due to borrower complaints of lost documents, and to ensure that all borrowers were properly evaluated, Treasury began the Mortgage Modification Conversion Campaign in December 2009. This campaign prevented servicers from cancelling any trial modification during the conversion period. The campaign also required servicers to confirm borrower status and communicate to the borrower any missing documentation needed to convert to permanent modification.

That cancellations have only recently increased demonstrates how the conversion campaign pushed servicers to exhaust efforts to reach out to borrowers who lacked appropriate documentation before making a final determination of ineligibility. From the program's inception through February 2010, just 89,000 trial modifications had been cancelled. Between March and June, an additional 432,000 were cancelled, many of which had been in trials for over six months. Survey data show that the most common causes of trial cancellations were incomplete documentation, missed trial payments, and ineligibility due to verified income being below the 31 percent debt-to-income affordability requirement.

In addition to this concentrated effort to ensure proper evaluation for borrowers, MHA Compliance has performed a series of Second Look evaluations, in which they sample servicers' portfolios to make sure borrowers were appropriately evaluated for HAMP. As reported in the May 2010 MHA Public Report, these exhaustive reviews found that MHA Compliance disagreed with the servicer actions in only 3.9 percent of cases.

4. Given the servicers' performance, isn't it very important that Treasury have a website completely up and running by now that homeowners can log into in order to determine if their servicer has received their documentation submission? Such a website is now more critical than ever as homeowners can now be denied access to the program until documentation is submitted and confirmed. At a minimum, the website would reveal which servicers are sufficiently organized to handle documentation allowing the site to be used, much like the monthly HAMP reports, to publicly shame and pressure servicers into remaining up to date on informing homeowners of the status of their documentation.

A: The recently-enacted Wall Street Reform and Consumer Protection Act requires Treasury to maintain a website that includes a net present value calculator and make a reasonable effort to include on such website a method for homeowners to apply for a mortgage modification under HAMP. Treasury is currently evaluating the feasibility of a web-based application method.

5. Freddie Mac's audit of servicer compliance reported in the June HAMP report shows a high degree of agreement with servicer decisions but only with respect to whether servicers are complying with their solicitation requirements to encourage homeowners to apply. In truth, the audit of whether homeowners were appropriately denied acceptance into the program or into a permanent modification is the critical issue now. When do you expect to have results of this compliance review? And will that review be limited to simply a review of the homeowner's file, or will it be more comprehensive to include contacting borrowers for at least a random sample? Finally, has there been, or is there planned, an audit of the HAMP escalation process within the servicer itself? High volumes of complaints seem to indicate that the escalation process is not successfully resolving the documentation issues that are a driver of cancellations.

A: The information reported in the June report represents one of a number of different types of compliance activities (described in the report Appendix and in prior submissions to the Panel).

From its inception, the focus of Treasury's compliance reviews of servicers is ensuring that borrowers are properly evaluated for a HAMP modification using HAMP criteria. MHA Compliance's "Second Look" review process – which is a review of loans that have not been offered HAMP modifications to ensure that the exclusion or denial was appropriate –has for each servicer taken into consideration borrower complaints and has included in its statistical sample population individual loans that were denied and canceled. The evaluations in second look consider all aspects of servicers' requirements under HAMP related to eligibility, and not only the solicitation requirements. This data was included in the cited report. The second look loan file review is conducted at the related servicer, and we do not at this time intend to reach out to individual borrowers.

The information included in the report is evaluated and discussed on an ongoing basis. At this time, we plan on continuing to report results of second look reviews on a quarterly basis.

The Homeownership Preservation Office will be issuing guidelines to servicers in late summer regarding their internal complaint and escalation processes. MHA Compliance will adjust its compliance activities after publication of its guidance to ensure that servicers are following the new requirements.

6. In your view, what misaligned incentives do servicers have in making HAMP modifications?

A: Servicers are fully incented to modify mortgage loans that they hold on their own portfolios, because they bear the risk of nonperformance. However, loans held in portfolio are a small percentage of the total mortgage loans outstanding. When servicing mortgages owned by other investors, current servicing compensation - negotiated in an era of low delinquency and few modifications - offers little incentive to engage in staff- and system-intensive loss mitigation activities. HAMP addresses this problem by providing compensation both for the initial effort involved in underwriting and documenting a modification and through pay-for-success incentives, which make servicers' relationship to HAMP modified loans a valuable asset as long as the borrower remains current.

Some observers of the HAMP program have suggested that servicers may have a disincentive to reduce principal on a mortgage loan because their servicing fees are typically based on a percentage of the outstanding principal amount of that loan. However, because servicers usually can only pay themselves servicing fees for loans that are current, servicers would therefore rather modify a loan (which may include reducing principal) in order to preserve some portion of the servicing fee, rather than have the loan go into default or foreclosure, in which case they would receive no servicing fees. Therefore the servicer has an incentive to modify a loan rather than see it default. In addition, because many servicers have a fiduciary relationship to pools of multiple investors, a decision not to reduce principal is likely influenced more by the servicers' inability to determine that principal reduction is in the best interest of all investors than by a reduction in servicing income.

7. What is Treasury's position on homeowners being hit with large balloon fees due immediately after a trial modification is cancelled in order to repay the benefit temporarily gained during the trial? Further, are servicers allowed to be charging late fees for the time homeowners are in a trial period, as some reports indicate?

A: During a trial period plan the servicer temporarily agrees to accept a reduced payment equal to 31 percent of the borrower's gross monthly income in order to test the borrower's willingness and ability to support this payment on a permanent basis. The trial plan notice provided to the borrower explains that during the trial period the scheduled loan terms do not change. The borrower still owes the full amount of principal and interest and late fees still accrue, though they must be waived if the loan is permanently modified under HAMP.

Treasury is concerned about reports that servicers may be asking borrowers who are not offered permanent modifications to repay the difference between the scheduled and trial plan payments as a lump sum. This is certainly not consistent with the intent of the program, which is to avoid foreclosure. Subject to further research, Treasury will consider future policy guidance to address this practice.

8. Without a Homeowner Advocate's Office to help homeowners with complaints and servicer issues, Treasury has been asking homeowners to rely on hotline numbers to resolve

their problems. What has been the outcome of these calls? How many homeowners have been helped? How many of these calls resulted in judgment that the servicer was in error?

A: Treasury is devoting considerable attention to ongoing improvements at the Homeowner's HOPE™ Hotline and the HAMP Solution Center (HSC). These call centers are the mechanisms for borrowers and their advocates to escalate their HAMP cases.

Recent data, which is being tallied and formatted for public release on a quarterly basis, has shown that 93 percent of all cases demonstrate no servicer error identified by the HOPE Hotline or HSC call center agent. Treasury is also actively engaged in strengthening both its servicer response validation techniques and also its quality control processes to ensure that servicer errors are properly identified and documented.

To date, over 1.3 million borrowers have called the HOPE Hotline seeking assistance. Data available currently in the MHA Public Report includes:

- Number of callers
- Outcome of calls
- Time it takes servicers to resolve homeowner problems that have been reported by third parties such as housing counselors, attorneys, and congressional and other government offices.
- Servicer handling of calls from homeowners (speed to answer, hang-up rates)
- Servicer share of homeowner complaints to the Homeowner's HOPE Hotline borrower call center.